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THE STRATEGIC CAPITAL RESERVE ACT OF 1985

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HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE,
TRADE AND MONETARY POLICY

OF THE

COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

FIRST SESSION

ON

H.R. 3498

A BILL TO STABILIZE INTERNATIONAL CURRENCY MARKETS IN SUPPORT OF FAIR GLOBAL COMPETITION

H.R. 3573

A BILL TO ACHIEVE STABLE AND REASONABLE EXCHANGE RATES FOR INTERNATIONAL CURRENCIES TO STRENGTHEN THE INTERNATIONAL ECONOMY AND PROVIDE FOR INTERNATIONAL ECONOMIC GROWTH

NOVEMBER 14 AND 19, 1985

Serial No. 99-54

Printed for the use of the
Committee on Banking, Finance and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
55-925 O WASHINGTON : 1986

55-925 O - 86 - 1

I

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CONTENTS

Text of: Page
- H.R. 3498 ... 3
- H.R. 3573 ... 7

WITNESSES

November 14, 1985

Bradley, Hon. Bill, U.S. Senator from the State of New Jersey ... 14
- Prepared statement ... 19

Lundine, Hon. Stan, a Representative in Congress from the State of New York ... 26
- Prepared statement ... 35

Poole, William, professor of economics, Brown University, and former member of the Council of Economic Advisers ... 40
- Prepared statement ... 46

WITNESSES

November 19, 1985

Bergsten, C. Fred, director, Institute for International Economics ... 112
- Prepared statement ... 117

Fox, Lawrence A., vice president, international economic affairs, National Association of Manufacturers ... 140
- Prepared statement ... 143

Mulford, Hon. David C., Assistant Secretary of the Treasury for International Affairs ... 90
- Prepared statement ... 94

Niskanen, William A., president of the CATO Institute, former member of the Council of Economic Advisers ... 130
- Prepared statement ... 133

Pease, Hon. Donald J., a Representative in Congress from the State of Ohio ... 81
- Prepared statement ... 85

Material Submitted for Inclusion in the Record

Caterpillar Tractor Co., letter from H. Richard Kahler, manager, governmental affairs, dated November 21, 1985 ... 27

LaFalce, Hon. John J., a Representative in Congress from the State of New York, opening statement ... 79

THE STRATEGIC CAPITAL RESERVE ACT OF 1985

THURSDAY, NOVEMBER 14, 1985

House of Representatives,
Subcommittee on International Finance,
Trade and Monetary Policy,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 10:30 a.m., in room 2222, Rayburn House Office Building, Hon. Stephen L. Neal (chairman of the subcommittee) presiding.

Present: Chairman Neal; Representatives Levin, Kleczka, Manton, Leach, Parris, McCollum, Kolbe, and McMillan.

Chairman **Neal**. I would like to call the subcommittee to order at this time. This morning we begin 2 days of hearings on two bills, H.R. 3498 and H.R. 3573, both introduced by our distinguished colleague Stan Lundine. The second hearing will be on November 19, and we plan markup on November 21.

At the outset I want to make it very clear that I must oppose the first of these bills, H.R. 3498, and that I have some serious reservations about the second. I nonetheless recognize the importance of the issue they address—the extraordinarily high foreign exchange value of the dollar. I also recognize a tremendous amount of congressional concern over this issue, and a desire for us to take some forceful action.

The action called for in these bills reflects the recommendations put forward recently by the Democratic Trade Task Force. Mr. Lundine, the sponsor of these two bills, was the chairman of the Working Group on the Dollar of that task force. He is codifying, in these bills, the conclusions of his working group, and of the task force. He has asked the subcommittee to move forward with these bills. I am pleased to honor the request that we consider them, since I think they should be given a full and fair hearing, and since I hold Mr. Lundine in such enormously high regard.

Through questions and subsequent statements, I will lay out my objections to these bills. When the time comes I will urge Members to vote against them, in their current form. At this point I want only to urge Members to take a very close look at what these bills actually contain. It is quite possible to regard these bills as symbolic statements of congressional concern over the high dollar, as signals that Congress wants something to be done about it.

It is quite possible to overlook the actual policies spelled out in these bills, and focus instead on the political importance of doing something about the dollar, without paying, I think, enough attention to the details. If seen in that light, these bills will no doubt command a lot of support.

I want to try and take a different approach, and focus on the actual policies enshrined in these bills. I hope to point out the dangers, perhaps unanticipated, that could flow from these policies. I hope to make it clear that the current dollar-trade problem is not isolated from the rest of the economy, and that the policies spelled out in these bills cannot solve it without causing serious problems elsewhere in the economy.

I will stress that the greatest danger posed by these policies would infect the entire economy, in the form of a resurgence of inflation. I will argue my case against these bills on the assumption that when we vote on bills we intend to support exactly what they require, and have weighed carefully their possible consequences.

[The texts of H.R. 3498 and H.R. 3573 follow:]

I

99TH CONGRESS
1ST SESSION

H. R. 3498

To stabilize international currency markets in support of fair global competition.

IN THE HOUSE OF REPRESENTATIVES

OCTOBER 3, 1985

Mr. LUNDINE introduced the following bill; which was referred to the Committee on Banking, Finance and Urban Affairs

---

A BILL

To stabilize international currency markets in support of fair global competition.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act may be cited as the "Strategic Capital Reserve Act of 1985".

ESTABLISHMENT OF RESERVE

SEC. 2. There is established in the Treasury of the United States a Strategic Capital Reserve which shall be available to the Board of Governors of the Federal Reserve System and the Secretary of the Treasury for the purpose of purchases of foreign currencies under section 3 and sales of such currencies in accordance with section 4, as determined by the Board and the Secretary.

PURCHASES OF FOREIGN CURRENCIES

SEC. 3. During any fiscal quarter when—

(1) the current account deficit has exceeded one and one-half percent of the gross national product for the most recent four consecutive quarters; and

(2) the trade-weighted exchange rate of the dollar is 15 per centum or more above the equilibrium rate (that rate which would be required to bring the current account into balance);

the Board of Governors of the Federal Reserve System and the Secretary of the Treasury shall purchase foreign currencies, including Japanese yen, German marks, and British pounds, in amounts not less than $3,000,000,000 but not more than the value of the current account deficit during the previous quarter.

SALES OF CURRENCIES

SEC. 4. (a) The Board of Governors of the Federal Reserve System and the Secretary of the Treasury may, from time to time, sell currencies from the reserve established under section 2 in order to prevent sudden and disruptive drops in the value of the dollar or to calm disorderly markets, except as provided in subsection (b).

(b) The authority conferred by this section may not be exercised in any quarter in which the authority conferred by section 3 may be exercised to counteract or offset gradual, orderly declines in the value of the dollar resulting from purchases of foreign currencies under section 3.

MONETARY POLICY

SEC. 5. The Board of Governors of the Federal Reserve System shall disregard any purchase of currency authorized or executed under section 3 in the formulation and conduct of monetary policy.

CONSULTATION

SEC. 6. The Chairman of the Board of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury shall consult at least quarterly with the central banks of the Federal Republic of Germany, Japan, the United Kingdom, and France in order to coordinate foreign exchange operations.

ANNUAL REPORT

SEC. 7. The Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury shall report annually to the Congress on the impact of currency transactions under this Act on foreign exchange markets. The first such report shall be transmitted not later than October 1, 1986.

NEGOTIATION

SEC. 8. The President shall enter into negotiations with the governments of the Group of Ten countries to establish an international financial commission which shall carry out a study and report, not later than one year after the date of enactment of this Act, to each of the Group of Ten countries on measures to reduce capital flow imbalances and volitility in capital flows caused by the macro-economic policies of major trading countries. The study by the commission shall include, but not be limited to, the following:

(1) the availability in each of the Group of Ten member countries of government securities of those countries that are comparable to each other in terms of maturity options, so that each country may make available comparable savings and investment vehicles to residents of all other countries;

(2) coordination among such countries of fiscal and monetary policies;

(3) coordination among the member countries of the tax treatment of investment earnings on domestic investments by foreign residents and foreign investments by domestic residents so as to reduce international capital flow imbalances; and

(4) coordination of foreign exchange operations by the central banks of such countries to avoid policies that are inconsistent with Strategic Capital Reserve operations.

○

the value of the dollar without precipitating too rapid and deep a decline;

(C) coordinated intervention in the foreign exchange markets between the Department of the Treasury and Federal Reserve Board with other major central bankers to reduce volatility in exchange rates;

(D) consideration of establishment of a system of "target zones" for exchange rates to be phased in over a period of years whereby parties would agree to define appropriate margins around an adjustable set of exchange rates devised to reflect international competitive realities and maintain a sustainable pattern of balance of payments; and

(E) consideration of a system whereby nations would agree to limit exchange rate fluctuations to narrow margins to be backed up by intervention in the exchange markets as necessary by country central banks and to negotiate other changes which are necessary to alter agreed upon limits.

(b) REPORT.—On each anniversary of the date of the enactment of this Act, the President shall report to the Congress on the progress made during the annual period covered by the report toward—

(1) reducing the value of the dollar and stabilizing it on international markets as a result of short term actions taken between the United States and other nations, and

(2) by adopting long-term reform of the international monetary system which will prevent future instability and disequilibrium in international exchange rates.

Each report shall include discussion of a timetable for implementing any agreed upon reforms of the system and a discussion of any remaining obstacles to their implementation.

(c) CONSEQUENTIAL EFFECT ON TRADE NEGOTIATIONS.—The President may not—

(1) commence multilateral negotiations under the General Agreement on Tariffs and Trade regarding the reduction or elimination of tariffs and non-tariff barriers to trade until the conference described in subsection (a)(1) is convened; or

(2) conclude any multilateral trade agreement resulting from negotiations described in paragraph (1) until the Congress receives a report under subsection (b) on the first annual period occurring after the convening of the conference described in subsection (a)(1).

99TH CONGRESS
1ST SESSION

H. R. 3573

To achieve stable and reasonable exchange rates for international currencies to strengthen the international economy and provide for international economic growth.

IN THE HOUSE OF REPRESENTATIVES

OCTOBER 16, 1985

Mr. LUNDINE (for himself, Mr. GEPHARDT, and Mr. BONKER) introduced the following bill; which was referred jointly to the Committees on Banking, Finance and Urban Affairs and Ways and Means

---

A BILL

To achieve stable and reasonable exchange rates for international currencies to strengthen the international economy and provide for international economic growth.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Trade Equity and Growth Act of 1985".

SEC. 2. FINDINGS AND PURPOSES.

(a) FINDINGS.—The Congress finds that—

(1) there has been substantial exchange rate volatility and disequilibrium involving international curren-

cies which is threatening the stability of the international financial and trade system;

(2) the present alignment of currency values in the world does not reflect the underlying competitive realities of national economies or market forces;

(3) the dollar, the major reserve currency in the international financial system, increased overall in value on a trade-weighted basis by 74 percent between the third quarter of 1980 and the first quarter of 1985;

(4) the high value of the dollar is not justified given today's competitive realities, and in fact, is doing serious damage to the long term competitive outlook for industrial and agricultural sectors in the United States;

(5) as much as 60 percent of the $123 billion United States merchandise trade deficit in 1984 was due to the inflated value of the dollar;

(6) the United States trade deficit has resulted in the loss of over 2 million jobs from lost exports markets and the movement of many United States industries to offshore production;

(7) the inflated value of the dollar is having a particularly damaging impact on debt-ridden developing countries trying to service their debts which are denominated in dollars; and

(8) the present volatility and disequilibrium in the exchange rate system will not be corrected without some modification to the existing system of floating exchange rates in place today.

(b) PURPOSE.—It is the purpose of this Act to—

(1) establish a national policy to reduce and stabilize at a reasonable level the inflated value of the dollar;

(2) reform the international monetary system to achieve long-term stability and equity in the exchange rates of the dollar and other currencies; and

(3) achieve border convergence of national economic policies to stimulate international economic growth and opportunity.

SEC. 3. UNITED STATES POLICY.

The Congress declares that achievement of an orderly movement to lower and stable exchange rates for the dollar is a primary objective of United States economic policy.

SEC. 4. PRESIDENTIAL ACTION TO ACHIEVE POLICY.

(a) IN GENERAL.—The President, in consultation with the Chairman and members of the Federal Reserve Board of the United States, the Secretary of the Treasury, and other officers of the United States, shall take the following steps to achieve the purposes of this Act:

(1) Immediately convene an international conference on the international monetary system for purposes of reviewing the present inadequacies of the present system of floating exchange rates and to develop a consensus on reform of that system to provide for the long term exchange rate stability necessary for a strengthened world trade and financial system.

(2) The proposed agenda for the conference required under paragraph (1) shall include study and discussion of proposals for short term action and long term reform of the international monetary system which includes, but is not limited to—

(A) ways to improve the convergence of individual country economic performance to strengthen the symmetry of the interaction of individual national economic policies in the international system, including a discussion of timing and ways the United States intends to reduce its budget deficit, along with ways the Japanese and European economies intend to stimulate their economies to create more world-wide demand to stimulate world growth;

(B) enhanced cooperation between the Department of the Treasury and Federal Reserve Board and other major central banks to reduce

SEC. 5. EQUILIBRIUM IN CURRENT ACCOUNT DEFICITS.

(a) DETERMINATIONS.—The Secretary of the Treasury, in consultation with the Board of Governors of the Federal Reserve System, shall—

(1) within 30 days after the date of the enactment of this Act determine, and notify the appropriate committees of the Congress of, the range of dollar exchange values that must be obtained if equilibrium in the current account deficits of the United States is to be restored by 1990; and

(2) develop and implement mechanisms that are necessary to achieve that equilibrium.

(b) REPORTS.—The Secretary of the Treasury shall make quarterly reports to the appropriate committees of the Congress regarding the carrying out of subsection (a)(2).

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Chairman **Neal**. Now it is time to proceed with the hearings. Our witnesses today include the sponsor of these bills, our distinguished colleague the Hon. Stan Lundine; the distinguished Senator from New Jersey, the Hon. Bill Bradley; and Prof. William Poole of Brown University, a former member of the Council of Economic Advisers. A fourth witness, Lee Morgan, former chairman of the Caterpillar Tractor Co., was scheduled to testify in favor of these bills. Unfortunately, he was prevented by adverse weather from making it today. We will distribute his statement and put it in the record.

I will ask if other Members have statements at this time.

If it is all right with our witnesses, we would like to hear from Senator Bradley first, and Congressman Lundine, and then Professor Poole. If that is all right, Senator, we would like to hear from you at this time. Thank you very much for coming over.

STATEMENT OF HON. BILL BRADLEY, U.S. SENATOR FROM THE STATE OF NEW JERSEY

Senator **Bradley**. Thank you very much, Mr. Chairman, for that warm but somewhat discouraging opening statement. I hope that in the course of these deliberations that some of the questions that you raise and some of the hesitations that you have expressed might be resolved positively.

Mr. Chairman, I would ask unanimous consent that a full statement that I have prepared be placed in the record.

Chairman **Neal**. Yes; without objection.

Senator **Bradley**. The cause of our trade crisis I believe has been a combination of world events and U.S. policy that has created an unprecedented rate of net capital inflow amounting to about $100 billion per year. This capital inflow has inflated the dollar to an uncompetitive exchange rate that functions like a 40- to 60-percent tax on all American products that compete internationally.

Four interrelated factors are responsible for the explosion of net U.S. capital inflows from a rate of about $10 billion in 1982 to a rate of $100 billion last year. First, in 1982, when Mexico burst on the scene as a result of low world oil prices and high U.S. interest rates, forcing Mexico to threaten default on international debt, the ensuing debt crisis brought new lending from U.S. commercial banks to a halt, and accelerated the flight of private capital from countries all across Latin and South America, countries like Venezuela and Argentina.

Between 1982 and 1984, for example, U.S. gross capital inflows remained steady at about $90 billion per year, while gross capital outflows, largely bank loans, shrank from $120 billion a year to only $20 billion. It dropped by $100 billion. That is the first factor: the debt crisis and its impact on capital flows.

The second factor relating to our current trade problem that I believe is directly related to the value of the dollar, was the 1981 tax cut and the U.S. Federal budget deficit that jumped from $64 billion to $148 billion in 1982, an increase of 131 percent. The Treasury was forced to borrow to make up the difference. That put unprecedented strain on U.S. capital markets and a further upward pressure on interest rates. The debt crisis and new U.S.

Government borrowing combined to divert world capital from Latin America to this country.

The third factor, coming in November of the following year, was that the Reagan administration urged the Nakasone government to liberalize Japanese financial markets—which they did. The liberalization consisted principally of measures designed to facilitate capital flows from Japan to the United States. Last year those capital flows amounted to about $40 billion

The forth factor is that the administration repeatedly asserted and demonstrated its unwillingness to intervene in international currency markets, prompting speculators to acquire dollar denominated assets. They reasoned that without Government intervention, speculative pressure taking advantage of the fundmentals that I have just mentioned would push the dollar up, guaranteeing high returns on dollar investments solely because of exchange rate movements.

And I might mention that in the last 2 days, a trader told me the story of pound bonds being issued at a 17-percent rate, which, after the pound increased, yielded a 50-percent investment.

Mr. Chairman, the debt crisis, the U.S. budget deficit, the one-way liberalization of Japanese capital markets and speculation predicated on our unwillingness to intervene all combine to create an unprecedented rate of net U.S. capital inflow.

This inflow of capital, while welcome in the investment sectors, has simultaneously inflated the dollar on world markets to completely uncompetitive exchange rates. These exchange rates have caused a hidden recession among trade-sensitive American industries.

A critical question to ask is whether the inflow of foreign capital helped industry retool. The statistics are helpful here. The average annual rate of capital expenditures on plant and equipment in the United States between 1981 and 1983 was about $275 billion, while the average rate in the period 1978 to 1980 was $305 billion, both in constant 1984 dollars. Since new capital has not been financing a private sector investment surge, there has been no positive effect of net capital inflows on business investment to offset the damaging impact on the value of the dollar.

Mr. Chairman, to resolve our trade crisis, we have to reverse the four trends creating net capital inflows that I have described, the debt, the budget deficit, the flow from Japan, and speculation.

We clearly could and should enact legislation to ensure that American investors enjoy investment opportunities and tax treatment in Japan comparable to the opportunities in tax treatment enjoyed by Japanese investors in the United States, and we should encourage Japan to divert its capital outflows to capital-poor countries such as Mexico, Peru, and Brazil. But these measures would have a relatively small impact on the overall capital flow imbalances plaguing the world trading system today. What we need is a transition strategy to put American industry back on its feet until longer-term measures can take effect.

In May of this year in the Senate, I offered a resolution urging the Secretary of the Treasury and the Federal Reserve Board to consult with G-5 finance ministers to bring down the value of the dollar. That proposal won strong bipartisan support in the Senate.

It passed the Senate, and it made it through conference with the House, and it is now section 810 of the Foreign Relations Authorization Act of 1986.

Just before the August recess, in the Senate, I introduced the Strategic Capital Reserve Act to improve the competitiveness of the dollar and to stabilize international currency markets. Stan Lundine introduced an identical bill in the House. Two months later, the administration announced an agreement between the G-5 ministers to bring down the value of the dollar. The dollar immediately dropped 6 percent against most foreign currencies and over the next 2 weeks several central banks intervened with between $3 and $4 billion to keep the dollar at the lower rate.

Mr. Chairman, it seems to me that this is a positive direction that the administration has taken, and that the Strategic Capital Reserve Act could hold the administration's feet to the fire, to make sure they continue to follow their stated intention to intervene in order to get the value of the dollar down.

There are three major provisions of the Strategic Capital Reserve Act. The first directs the Federal Reserve and the Treasury to sell dollars or purchase at least $3 billion in foreign securities in any quarter in which the previous year's current account deficit exceeded 1½ percent of GNP, which in 1984 would be $50 billion, and in which the value of the dollar is 15 percent greater than what it would have to be in order to bring the current account into balance.

The second major provision is that the Federal Reserve should not raise cash for these purchases in the domestic bond market. In other words, it should carry out unsterilized transactions, because otherwise foreign currency purchases would raise interest rates.

Third, the act directs the President to negotiate to establish an international commission of representatives from the G-10 countries to investigate ways of stabilizing the world financial system. The areas that the commission should consider would be coordinated macroeconomic strategy, coordinated intervention, tax treatment, and also the issuance of debt instruments of internationally comparable type and variety.

The main strength of this proposal I believe is that it lays out a clear, credible plan to improve the competitiveness of the dollar. The bill sets out clearly the minimum level of currency intervention that markets should expect when capital flows threaten to distort trade patterns. And it improves greatly the credibility of administration announcements concerning the desirability of realigning the dollar, and it does so by calling for unsterilized intervention.

Mr. Chairman, I would say that only unsterilized intervention is likely to have a long-term impact on the value of the dollar. Sterilized intervention can have an impact on the value of the dollar only if it simultaneously raises real interest rates. In othe words, sterilized intervention can improve the competitiveness of the dollar only if it has a recessionary impact on capital markets.

The intervention last winter is probably an example of sterilization. It had no lasting impact because the markets didn't believe the U.S. Government supported it. This bill is much more likely to have an effect on the exchange rate of the dollar, because its enactment would indicate a seriousness of purpose that has been lacking up to now.

In addition, the act establishes a strategic reserve of foreign currencies that would provide us with a tool to cushion any sharp or disruptive fall in the value of the dollar. We can't wait for a financial crisis to prove the necessity of such a reserve any more than we can hope the trade deficit will disappear while capital inflows swamp the currency markets.

Mr. Chairman, if the strategic capital reserve had been enacted last year, each fiscal quarter would have met the conditions for a $3 billion minimum intervention. Thus the bill would have required the purchase of about $12 billion worth of foreign securities in new money. The Federal Reserve actually expanded the monetary base last year by purchasing $12.5 billion worth of U.S. Government securities with new money.

Under the Strategic Capital Reserve Act, the Federal Reserve would have been free to decide whether economic considerations apart from exchange rate considerations required additional money supply expansion or not. In any case, this act does not reduce the freedom of the Federal Reserve to pursue independent money supply targets. Moreover, there have been very few years when all four quarters would have triggered under the provisions of this act.

Mr. Chairman, let me say what this bill does not directly address. It does not directly address the problem of unfair foreign trade barriers. But the strategic capital reserve bill does begin to move us toward a resolution of the other problems that I have sketched, the Big Four. As to the debt crisis, for example, the Federal Reserve and the Treasury could make limited strategic capital reserve purchases of Latin American securities to alleviate the severe debt burden under which some Latin American countries are suffering.

These purchases would function like small, long-term official loans to capital-poor countries. To encourage serious action on reducing the Federal budget deficit, Congress could release the administration from strategic capital reserve intervention requirements in any fiscal quarter that the budget deficit ran at an annualized rate less than 3 percent of GNP. To ensure international coordination of exchange rate policies, the Congress could release the administration from intervention requirements in any quarter that any other central banks had intervened in accordance with certain specified agreements.

Frankly, if there is growing support for reform of the international monetary system, Congress could release the administration from strategic capital reserve requirements once the administration had initiated a conference to consider a specific agenda for an international monetary conference.

I mention these possibilities only to illustrate the flexibility of the framework that the strategic capital reserve provides.

The Strategic Capital Reserve Act recommends an active role for Congress in setting trade and macroeconomic policy, but it seeks an alternative to special interest activism that I believe has eroded congressional effectiveness and fostered cynicism about Congress' ability to provide economic leadership.

The administration's macroeconomic policy, although hardly activist, is not free from the charge of promoting special interests either. Under present conditions, it appears more like an industrial policy favoring certain investment and trade-related sectors. It does so at the expense of an exchange rate tax on sectors such as manufacturing, mining, and agriculture, that compete internationally.

If you are in a defense industry or if you are in a services industry or if you are in some investment sectors, particularly those that sell Government securities or if you are in the merger business, you are doing pretty well, but if you are in mining, agriculture or manufacturing, you are being hurt immensely by the value of the dollar. The strategic capital reserve very simply seeks to reverse this. I think, frankly, we should reward ourselves as consumers, and challenge ourselves as producers. Instead, we are indebting ourselves as consumers and punishing ourselves as producers. I think that is backwards, and I think the strategic capital reserve is one way to begin to alter that.

I thank the chairman very much for the opportunity.

[The prepared statement of Senator Bradley follows:]

Bill Bradley
U.S. SENATOR
Democrat New Jersey
731 Hart Senate Office Building • Washington, D.C. 20510 • 202/224-3224

BRADLEY PROMOTES STRATEGIC CAPITAL RESERVE ACT

For Immediate Release: Thursday, November 14, 1985
Contact: Lisbeth Pettengill, John Steele

Senator Bill Bradley (D-N.J.) today spoke before the House Banking Subcommittee in support of his legislation that mandates intervention in the foreign exchange market. The Senator had just finished sponsoring a two-day monetary conference on exchange rates and the dollar.

In his remarks Senator Bradley said, "The conference that Jack Kemp and I co-sponsored this week points out some areas of fairly broad agreement. For example, there is a clear possibility of a destabilizing run on the dollar if investors lose confidence. We lack the tools to deal with such a run since we do not have sizeable international capital reserves.

"Virtually every participant agreed that the key to addressing fundamental imbalances is better international macroeconomic coordination. Better coordination may be the single most important element of our future prosperity; continuing lack of coordination may be the greatest threat to our economic security.

The complete text of the Senator's testimony is attached.

STRATEGIC CAPITAL RESERVE TESTIMONY
Senator Bill Bradley
November 14, 1985

We may not be at the point of ready-made consensus on international monetary reform. But the conference that Jack Kemp and I have co-sponsored this week points out some areas of fairly broad agreement. For example, there is a clear possibility of a destabilizing run on the dollar if investors lose confidence. We lack the tools to deal with such a run since we do not have sizeable international capital reserves. In addition, some participants felt that the G-5 accord has succeeded in bursting a speculative bubble. But there was concern that unless the Administration follows through on its commitment to concerted intervention, that intervention may unravel. We must make sure that any transition strategy we adopt to improve the competitiveness of the dollar lasts long enough to allow us to solve our fundamental economic problems. Virtually every participant agreed that the key to addressing fundamental imbalances is better international macroeconomic coordination. The European Monetary System, for example, may owe its success to the relatively high degree of internal convergence of macro policies in Europe. Most important, international monetary reform, towards which the Strategic Capital Reserve is a first step, may provide a means to embrace better international macro coordination. Better coordination may be the single most important element of our future prosperity; continuing lack of coordination may the greatest threat to our economic security.

The cause of our trade crisis has been a combination of world events and U.S. policy that has created unprecedented rates of net capital inflow amounting to $100 billion per year. These capital flows have inflated the dollar to an uncompetitive exchange rate that functions like a 40% to 60% tax on all American products that compete internationally.

Four interrelated factors are responsible for the explosion of net U.S. capital inflows from a rate of $10 billion in 1982 to a rate of $100 billion last year. First, in 1982, a combination of low world oil and resource commodity prices together with rising U.S. interest rates forced Mexico to threaten default on its international debt. The ensuing Latin American debt crisis brought new lending by U.S. commercial banks to a halt, and accelerated the flight of private capital from countries like Venezuela and

Argentina. Between 1982 and 1984, for example, U.S. gross capital inflows remained steady at about $90 billion per year, while gross capital outflows shrank from $120 billion to $20 billion per year. Second, as a result of the 1981 tax cuts, the U.S. federal budget deficit (measured by national product accounts) jumped from $64 billion to $148 billion in 1982--an increase of 131%. The Treasury was forced to borrow to make up the difference, putting unprecedented strain on U.S. capital markets and further upward pressure on U.S. interest rates. The debt crisis and new U.S. government borrowing combined to divert world capital from Latin America to this country.

Third, in November of the following year, the Reagan Administration urged Nakasone to liberalize Japanese financial markets. The liberalization consisted principally of measures designed to facilitate capital flows from Japan to the U.S.: lifting restrictions on foreigners' ability to issue Samurai bonds, relaxation of Japanese "administrative guidance" that restricted overseas lending by Japanese banks, relaxation of Japanese restrictions on trading of foreign commercial paper, and relaxation of restrictions on overseas bank accounts held by Japanese residents. The reason for emphasizing liberalization of Japanese capital outflows to the U.S. no doubt reflected concern about the relatively high cost of capital to American businesses compared with Japanese businesses. But the resulting upward pressure on the dollar has harmed American businesses more than Japanese capital has helped them.

Fourth, the Administration repeatedly asserted and demonstrated its unwillingness to intervene in international currency markets, prompting speculators to acquire dollar-denominated assets. They reasoned that, without government intervention, speculative pressure and the fundamentals I have just listed would push the dollar up, guaranteeing high returns on dollar investments solely because of exchange rate movements. The debt crisis, the U.S. budget deficit, the one-way liberalization of Japanese capital markets, and speculation predicated on our unwillingness to intervene, combined to create unprecedented rates of net U.S. capital inflow. This inflow of capital, while welcome in investment sectors, has simultaneously inflated the dollar on world markets to completely uncompetitive exchange rates. These exchange rates have caused a hidden recession among trade-sensitive American industries.

Has the inflow of foreign capital helped American industry retool? According to the Economic Report of the

President, the average annual rate of capital expenditure on plant and equipment in the U.S. between 1981 and 1983 was 10% lower than the average rate of expenditure between 1978 and 1980. The average rate was $275 billion between 1981 and 1983 in constant 1984 dollars, while the average rate was $305 billion between 1978 and 1980 in constant 1984 dollars. Since the new capital has not been financing a private sector investment surge, there has been no positive effect of net capital inflows on business investment to offset the damaging impact on the dollar.

To resolve our trade crisis, we must reverse the four trends creating net capital inflows that I have described. But most of the policy tools available to accomplish this would either take a long time to have an effect or have a relatively minor impact. Measures to relieve the debt burden in Latin America ultimately depend on new confidence in Latin American economies on the part of commercial bankers. But this requires fundamental changes in debtor nations' economic structure. Such changes demand generous windows of time to avoid hardship in the debtor countries. The Senate has just enacted draconian legislation to reduce the federal budget deficit, but even this will require five years. And the Senate demonstrated the day after passage of Gramm-Rudman that it did not have the will to cut the budget deficit in accordance with the prescriptions of the bill. We could and should enact legislation to ensure that American investors enjoy investment opportunities and tax treatment in Japan comparable to the opportunities and tax treatment enjoyed by Japanese investors in the U.S. And we should encourage Japan to divert its capital outflows to capital-poor countries such as Mexico, Peru, and Brazil. But these measures would have a relatively small impact on the overall capital flow imbalances plaguing the world trading system today. What we need is a transition strategy to put American industry back on its feet until longer-term measures can take effect.

In May of this year, a resolution I offered urging the Secretary of the Treasury and the Federal Reserve Board to consult with the G-5 Finance Ministers to bring down the value of the dollar, won the strong, bi-partisan support of the Senate. The House agreed to the resolution in conference, and it became Section 810 of the Foreign Relations Authorization Act of 1986. Just before the August recess, I introduced the Strategic Capital Reserve Act, laying out a plan for orderly, unsterilized intervention to improve the competitiveness of the dollar and to stabilize international currency markets. Two months later, the Administration announced an agreement between the G-5 Finance Ministers to bring down the value of the dollar. The dollar immediately dropped 6% against most foreign currencies, and over the next two weeks several central banks intervened with between $3 billion and $4 billion to keep the dollar at the lower rate.

On October 8, the Journal of Commerce reported that Japanese Finance Minister Takeshita pledged to Secretary Baker that Japan would continue to follow up the G-5 meeting and would work to keep the dollar's value low in relation to the yen. Contributions by Japan, however, will not convince Wall Street traders that the major player--the U.S. government--is serious about overseeing the value of the dollar. Until the Administration lays out a plan for monetary and exchange policy designed to stabilize international currency markets, Wall Street traders will regard calls for intervention as side-shows staged for the benefit of Congress. And as long as traders suspect that the Administration is not serious about intervention, the private capital markets will have no reason to stop moving speculatively into dollar-denominated assets. Now more than ever, we need to lay out policy reflecting the concern of this government about the effect of the value of the dollar on U.S. industrial competitiveness.

The Strategic Capital Reserve Act (S.1571) directs the Federal Reserve and the Treasury to purchase foreign currencies whenever net capital inflows seriously threaten to disrupt trade patterns. The act has three provisions. First, it directs the Federal Reserve and the Treasury to purchase at least $3 billion in foreign securities during any fiscal quarter when two conditions are met. The first condition is that each of the previous four quarters' current account deficit must have run at a yearly rate exceeding 1.5% of GNP, or about $50 billion in 1984. The second condition is that the dollar must be 15% higher than the level required to balance the current account. Whenever these two conditions are met, we have a serious trade problem on our hands. The second provision directs the Federal Reserve not to raise cash for these purchases in the domestic bond market. Otherwise, the purchases would raise interest rates. Because of the impact on interst rates, raising cash in domestic bond markets to finance purchases in foreign currency markets is called sterilizing the intervention. So the second provision calls for unsterilized intervention. Third, the act directs the President to negotiate to establish an international commission of representatives from the G-10 countries to investigate ways of stabilizing the world financial system. The act also calls for quarterly international consultations to coordinate Strategic Capital Reserve operations with other major central banks, and caps allowable interventions at the quarterly level of the current account deficit. Representative Lundine introduced an identical bill as H.R. 3498 on October 3 in the House.

The main strength of the proposal is that it lays out a clear, credible plan to improve the competitiveness of the dollar. The bill sets out clearly the minimum level of currency intervention that markets should expect when capital flows threaten to distort trade patterns. And it improves greatly the credibility of Administration announcements concerning the desirability of realigning the dollar by calling for unsterilized intervention. Only unsterilized intervention is likely to have a long-term impact on the value of the dollar. Sterilized intervention can have an impact on the value of the dollar only if it simultaneously raises real interest rates. In other words, sterilized intervention can improve the competitiveness of the dollar only if it has a recessionary impact on capital markets. The intervention last winter is probably an example of sterilization: it had no lasting impact because the markets did not believe the U.S. government supported it. This bill is much more likely to have an effect on the exchange rate of the dollar because its enactment would indicate a seriousness of purpose that has been lacking up to now.

In addition, the act establishes a strategic reserve of foreign currencies that would provide us with a tool to cushion any sharp or disruptive fall in the value of the dollar. We cannot wait for a financial crisis to prove the necessity of such a reserve any more than we can hope the trade deficit will disappear while capital inflows swamp the currency markets.

If the Strategic Capital Reserve had been enacted last year, each fiscal quarter would have met the conditions for a $3 billion minimum intervention. Thus, the bill would have required the purchase of $12 billion worth of foreign securities with new money. The Federal Reserve actually expanded the monetary base last year by purchasing $12.5 billion worth of U.S. government securities with new money. Under the Strategic Capital Reserve Act, the Federal Reserve would have been free to decide whether economic considerations apart from the exchange rate required additional money supply expansion or not. In any case, this act does not reduce the freedom of the Federal Reserve to pursue independent money supply targets. Moreover, there have been very few years when all four quarters would have triggered its provisions.

The Strategic Capital Reserve does not address the problem of unfair foreign trade practices. We must, at a minimum, harness private sector initiatives to respond adequately to unfair foreign trade barriers. I have introduced the Trade Partnership Act (S.1669) to promote just such private sector initiatives. But the Strategic Capital Reserve does begin to move us toward a resolution of the other problems I have sketched. As to the debt crisis, for example, the Federal Reserve and the Treasury could make limited Strategic Capital Reserve purchases of Latin American securities to alleviate the severe debt burden under which some Latin American countries are suffering. These purchases would function like small, long-term official loans to capital-poor countries. To encourage serious action on reducing the federal budget deficit, Congress could release the Administration from Strategic Capital Reserve intervention requirements in any fiscal quarter that the budget deficit ran at an annualized rate less than 3% of GNP. To ensure international coordination of exchange rate policies, Congress could release the Administration from intervention requirements in any quarter that other central banks had intervened in accordance with certain agreements. And if support for a new international monetary conference continues to grow, Congress could release the Administration from Strategic Capital Reserve requirements once the Administration had initiated a conference to consider a specific agenda of international monetary reforms. I mention these possibilities to illustrate the flexibility of the framework that the Strategic Capital Reserve provides.

The Strategic Capital Reserve Act recommends an active role for Congress in setting trade and macroeconomic policy. But it seeks an alternative to special interest activism that has eroded Congressional effectiveness and fostered cynicism about Congress' ability to provide economic leadership. The Administration's macroeconomic policy, although hardly activist, is not free from the charge of promoting special interests, either. Under present conditions, it appears more and more like an industrial policy favoring certain investment and trade-insulated sectors. It does so at the expense of an exchange rate tax on sectors like manufacturing, mining, and agriculture, that compete internationally. The Strategic Capital Reserve, very simply, seeks to reverse this. We should reward ourselves as consumers, and challenge ourselves as producers; instead we are indebting ourselves as consumers, and punishing ourselves as producers.

Chairman NEAL. Thank you, Senator, very much.

Can you stay with us for a while? I sure hope so.

Senator BRADLEY. Yes, sir, I will be pleased to stay.

Chairman NEAL. All right, sir. Thanks a lot.

Let me just say again my opening statement was a bit immodest. You know, I may not prevail with the subcommittee. We have held hearings on this subject over time and the subcommittee has spent a good time on it and I, as a result of that, have become convinced that the danger of reinflating the economy by the unsterilized intervention that you suggest is so great that just on that level alone I would guess that it is not worth the effort, but also my concern is that it probably wouldn't be effective over time, because if it were to reinflate the economy, it would run up interest rates again, and there are some other problems we will get into in the question-and-answer period.

Senator BRADLEY. Fine.

Chairman NEAL. As I say, I certainly respect your opinions and those of Congressman Lundine immensely, and the subcommittee may agree with you.

Senator BRADLEY. However the chairman would like to proceed. If you would like me to deal with those now or wait, I will be pleased to wait.

Chairman NEAL. I really think it would help to hear from Congressman Lundine and also Professor Poole. Professor Poole in his testimony points out some of the problems, and it might give us a chance to have a little better dialog on it.

Stan, could we hear from you now. We will put your entire statement in the record, without objection.

STATEMENT OF HON. STAN LUNDINE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. LUNDINE. Yes; that is what I was going to ask. This is a subject very important to me. I would like to just have a few minutes to talk to my colleagues rather than read the statement. I will try to be as brief as I can.

I would also like to put a letter I received from the Caterpillar Tractor Co. in the record at this point.

Chairman NEAL. Without objection, it is so ordered.

[The letter follows:]

CATERPILLAR TRACTOR CO.

Peoria, Illinois 61629

November 21, 1985

Mr. Stephen L. Neal, Chairman
Subcommittee on International Finance,
Trade and Monetary Policy
Banking, Finance and Urban Affairs Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I regret that Caterpillar was unable to provide a witness for your November 14 Subcommittee hearing concerning the strong dollar.

Hopefully, our written comments will assist you as you undertake your very important deliberations on how to deal with the problems associated with the international exchange rate system.

For nearly fours years Caterpillar has sought to bring the issue of currency imbalances -- specifically the "overvalued dollar" and its relation to the "undervalued yen" -- to the forefront of U.S. trade and economic concerns. Other organizations with which we are affiliated--like the Japan - U.S. Business Council--have seen the danger of a "too strong" dollar to the bilateral relationship between our two countries. Not surprisingly, American and Japanese businessmen understood that certain "protectionist" legislation that has been considered (and some enacted) by the House of Representatives reflected U.S. policymakers' concern about fundamental economic problems (like exchange rates) that were creating severe trade problems for U.S. interests.

Yet, while there has been some convergence of views among U.S. companies such as Caterpillar, our Japanese business counterparts, and enlightened members of Congress and the Administration on the seriousness of the exchange rate problem, it's only in the last few months that a serious effort has emerged to deal with the problem. The September 22 agreement among the Group of Five Finance Ministers regarding exchange rates is a critically important first step. We hope the initiative will establish the ongoing momentum necessary for exchange rates to return to an appropriate relationship and for U.S. companies to resume competition on the proverbial "level playing field".

We see only one danger in the G5 agreement, but it's an important one. Our concern is that its initial impact on international currency markets may cause the agreement to be perceived by some as an end unto itself. Though the dollar's value has adjusted in the last two months, it would be a serious mistake to declare victory and relegate this matter to the "old issues" file.

Until two months ago the world's money managers and other businessmen weren't convinced that the U.S. was concerned about the excessively strong dollar. Today that perception has changed, but so far only marginally. It's changed because we've applied a tournaquet, to stop the "bleeding" being caused by the dollar's strength. But the conversion isn't complete yet because the underlying economic problems that created the dollar's strength still exist. The patient is still ill!

For several years, Caterpillar spokesmen have argued with economic purists about the importance of exchange rate intervention. We've disagreed with the purists, by arguing that intervention could have some short-term benefits, bringing the dollar nearer its appropriate level and demonstrating U.S. resolve to have an appropriately valued currency. That point of view has been reinforced in recent weeks.

But the disagreement with the purists always stopped when we got to the point of considering intervention as a long-range solution. It just won't do the job. More fundamental, long-lasting changes are required. The President and Congress must keep these changes at the top of your lists of things to do.

To say that Caterpillar has been seriously hurt by exchange rate problems is an understatement. For several years we've watched the dollar strengthen steadily, severely undermining our competitiveness against our most formidable and determined competitor...Komatsu of Japan.

You've heard all the macroeconomic estimates of the impact of the dollar's strength, but some of these bear repeating:

- A loss of some two million U.S. jobs related to exports, a figure that's still on the rise.
- A reduction of U.S. GNP growth, due to the dramatic surge in inexpensive imports.
- An erosion of the U.S. industrial base and underutilization of our human capital.

And, perhaps most important, from a long-term perspective, is a change in international investment patterns. American companies have been forced to make decisions regarding "sourcing" of components and product that will result in a greater concentration of manufacturing (and related employment) outside the United States in the years ahead. A 1984 study, principally of the U.S. capital goods sector, reported that 77 percent of its respondents were placing increasingly greater reliance on "outsourcing". Reduced to its simplest terms, that means production and jobs are being moved outside the United States.

There is probably no more vivid example of the impact of this problem than Caterpillar and the U.S. communities in which it does most of its business.

In 1981, Caterpillar's last "normal" year, the company exported $3.5 billion of product from the United States to overseas buyers. That sales level produced a $3.3 billion positive balance of trade contribution and provided employment to some 31,000 U.S. Caterpillar employees.

Last year our exports produced a $1.1 billion positive balance of payments figure...down 60%. Half of the U.S. jobs that supported our exports four years ago are gone!

To stay competitive in world markets, Caterpillar machines are selling today at prices below 1981's. We've lost $1 billion, trying to maintain our position as industry leader, while we worked hard to control our own costs and talked to everyone that would listen about the need to address the exchange rate problem.

We're reducing manufacturing space by about 25%. A state-of-the-art foundry at Mapleton, Illinois, near Peoria, is being downsized. We're moving a great deal of production from one of our company's very best and most modern facilities in Davenport, Iowa to facilities in Grenoble, France and Glasgow, Scotland.

We will be importing a great deal more from abroad, both components and finished product, because of "sourcing" decisions we've had to make over the past few years. It's unlikely that we'll ever contribute as much to a positive U.S. balance of trade as we did in 1981. Decisions have been made, and while nothing is irreversible, basic economic conditions haven't changed enough yet to warrant an interruption of our move toward being a company that produces a higher portion of its product outside the United States.

The exchange system clearly went awry. It undermined the strength of Caterpillar, and many other U.S.-based companies like ours. U.S. industries and workers suffered ... perhaps irreversibly.

At the risk of sounding self-serving, I think Caterpillar has responded to its current competitiveness challenge in the proper way. We've reduced employment, manufacturing capacity, and all costs ...dramatically. In four years we've knocked 22 percent out of our basic cost structure. We'll accomplish another 15 percent in the next three years. We've recognized that we had some belt tightening to do, in an industry with uncertain growth prospects and increasingly aggressive low-cost competition. That's our part of the deal!

But the experience of the past four years has shown that our efforts must be complemented by government actions to control wide fluctuations in exchange rates that do not reflect basic economic conditions. Perhaps Caterpillar and some other U.S. companies got a little "fat" in the late 1970's, when exchange rate relationships made U.S.-produced goods highly competitive. The dramatic change of the 1980's has forced us to get our own house in order. Now we must hope that the feast or famine impact of exchange rates will be reduced.

Caterpillar wants to compete on the basis of quality, service and cost. We can, and will, do that if the external environment is a stable one. The deliberations of this Committee can help us move in that direction.

Sincerely,

H. Richard Kahler

H. Richard Kahler
Manager
Governmental Affairs

HRK:rmc

cc: Mr. Stan Lundine

Mr. Lundine. Mr. Lee Morgan was scheduled to testify on behalf of the Caterpillar Tractor Co. It is too bad that he could not come, because I think American business ought to be heard from on this as well, and he is a leading spokesman, having suffered with Caterpillar under some of the problems of the exchange rate imbalance.

Second, at the outset, let me express to you my appreciation for how you are going about this. It is easy to be somebody's friend when you agree with them. It is a little more difficult when you disagree. But you are being very courteous, and I deeply appreciate that, and I want all the other members of the subcommittee to understand that I appreciate that courtesy, as well, as I know I have already privately expressed it to you.

Chairman Neal. Thank you.

Mr. Lundine. The dollar is at least half of the trade problem. Some people say it is 70 percent of the trade problem, but it is at least half, and we just can't go on indefinitely running $150 billion trade deficits.

We, this year, became a debtor nation. If we continue to go on with the same kind of economy and the same kind of policies, by 1990 we will not only be the largest debtor nation, but the Institute for International Economics estimates that our debt will be larger than all the other nations of the world. There will come a time when we have to repay our debt, and we will be subject to the worst austerity this country has ever experienced, unless we take some corrective action.

The Strategic Capital Reserve Act has been well described by my colleague Bill Bradley, who really initiated it as he indicated on the Senate side. Let me just make a couple of additional observations.

The administration changed their policies this year, and the G-5 initiative is working. It has brought the yen down in relationship to the dollar. The point is, however, that this is a fundamental policy question, and the Congress should be heard on this. I know the administration doesn't want that. They never do. If you are running a business, you never want your board of directors to tell you what to do. You want to kind of have a meeting every once in awhile, and humor them. It is Congress' responsibility to set the fundamental policies, and when the exchange rate system is broke, we have to figure out how to repair it. Senator Bradley along with our colleague, Jack Kemp, hosted a major conference on this subject the last 2 days, and there were people from all over the world. They disagreed on many things, but they did not almost without exception disagree on one point, and that is the exchange rate system is broke. It is not working. Theoretical economics said that when you run a big trade deficit, your currency will depreciate and there will be an automatic balancing.

The problem is we have run a big trade deficit, and our currency has continued to appreciate, so all the Strategic Capital Reserve Act really does is support and strengthen the policies behind the action that the administration has, belatedly in my opinion, already taken, and it strengthens it by requiring unsterilized intervention, as Senator Bradley has indicated.

He calls it a transitional strategy. Perhaps that is a better word. I believe it is the short-term component to what needs to be done to get the dollar back in line with other currencies, to give us a fair competitive chance. If we are exporting or trying to right now, our goods are going out of this country with at least a 30-percent burden on them.

It is tough to be 30 percent better than the Canadians. In upstate New York we understand that. Incidentally the Canadians, are our biggest trading partner—and they are not even a part of the G-5. That is why it has got to be more systematic than it has been, and that is why the strategic capital reserve is needed.

Incidentally, they also needed to build up these currencies, so that the dollar won't precipitously fall. This could happen and could as the chairman has indicated reignite inflation and damage the U.S. economy.

I think that Senator Bradley's craftsmanship has been extraordinary, and that this transitional bill deserves a very serious attention, the very serious attention of the Congress and of this subcommittee.

But I also have introduced H.R. 3573, because I think we need to take long-term action. I am honest in admitting I am not certain what that action ought to be. That bill calls for a major international conference on exchange rates, to be called by the United States and to involve more than just the G-5 countries.

This really is long-term reform of the monetary system. The system is broke. Efforts to reform it need to be linked with a new round of GATT, the general agreement on trade and tariffs.

Such a negotiation should have two agendas. Number one, we have got to talk with the other nations of the world, particularly the advanced industrialized nations, more seriously about coordinating our macroeconomic policies. The annual summit and the other IMF meetings and all that just don't do it. We have got to, as we did with Bretton Woods in the 1940's, and as President Nixon did by getting the attention of the world in the early 1970's, we have got to take another look at it.

My sense is, and I think that a fair summary of what most people thought at the Kemp-Bradley conference, is that we have got to allow for the floating exchange rate, but probably within reference zones or target zones that would insure that rates would—not get out of line—up or—down. I would suggest that probably the mark, the yen and the dollar have to be viewed as the international currencies, and then the other currencies related to them. It has worked in Europe and it can work internationally, if we are willing to coordinate and we are willing to work together.

My second bill requires that such an international monetary reform conference or negotiations be commenced simultaneous with or prior to a new round of GATT. I support a new GATT round, but it must be accompanied by a re-examination of international monetary policies or it will be like trying to drive a car with one foot on the gas and one foot on the brake.

Unless we fix this international monetary system that is broke, we can remove these trade barriers, which can apply the GATT to services and do all these other things, but we are not going to come to a fair trading competitive system.

These bills are no substitute for deficit reduction. I don't want anyone, to think so. The chairman already has suggested that there is no easy cure for the problems of the dollar. Obviously the fundamentals are important.

What these bills do though is work with the fundamentals, not work against them as the current system has. Let me illustrate this point.

Floating exchange rates, have not adjusted economic fundamentals as theoretical economics suggested they would, and they haven't had the discipline that the old fixed exchange rates did. Under fixed rates it was a painful adjustment when you had to devalue your currency.

We don't have to do that today because speculators in international markets do it all the time. We need to reduce our budget deficit, and these kinds of measures will encourage us all the more to do that. They won't be a substitute for that necessary deficit-reduction action. In fact, obviously if we enter into an international negotiation of coordinated macroeconomic policies, you all know what the first thing is that every other nation is going to tell the United States it has to do.

We all know what we have to do before we even begin, and that is get our own fiscal house in order.

Second, with respect to inflation, I can't think of a better time to straigthen out this fundamental problem than right now. Commodity prices are low. There is no wage-price spiral that seems to be reigniting inflation. As Senator Bradley has pointed out, any increase in the growth of monetary targets that we are mandating is less than the Fed already engaged in to buy U.S. securities this past year. I have a consistent and strong record against inflation.

I am not insensitive to inflation pressure, but look at what is going on right now. Why do we have the highest real interest rates in the world—that is the difference between inflation and interest paid—that we have had since the 1920's? Because we have to service our debt, and because we have not had accommodative monetary policies.

Now these measures will straigthen out the exchange rate system. They will make us more competitive. They will accommodate a continuing concern with inflation.

Let's also talk about economic growth. Getting the dollar and the trade balance in line will not only help those sectors of the economy that are obviously affected such as manufacturing and mining, but I would submit to my colleagues that the other sectors of the economy, construction, housing and all the others, will not go on successfully, if we come crashing down because the trade deficit finally bursts. These measures are also consistent with an overall sound economic policy for economic growth.

This type of intervention will not tighten credit, as my colleague, Senator Bradley, has pointed out. In sum, we must find a moderate position between the rigidities of the fixed exchange rate system and the volatility, uncertainty, and stability of the floating rate system.

The Congress and the President should lead the world towards a consensus in this area.

In conclusion, let me say the Banking Committee has jurisdiction over this area of international monetary policy. We are at an extraordinarily important juncture in terms of our trade policy and our trade position. I would hate to see the Banking Committee fumble the ball or neglect to address this fundamental problem, leaving it to others in the other body or on other committees.

I hope that this subcommittee will indeed consider these measures. If they can be improved obviously I am open to improvement, but I think that a combination of a short-term necessary action to correct the obvious imbalance and a long-term negotiation to try to get us to a more moderate system eventually is necessary.

I sincerely thank the chairman. I thank the members who have paid attention. Obviously I feel strongly about this subject, and whatever we do I hope that we don't sit back and do nothing.

[The prepared statement of Congressman Lundine follows:]

STATEMENT OF CONGRESSMAN STAN LUNDINE

SUBCOMMITTEE ON INTERNATIONAL FINANCE, TRADE AND MONETARY POLICY

NOVEMBER 14, 1985

At the outset, I want to thank the Chairman for scheduling these hearings to consider H.R. 3498 and H.R. 3573 which I have introduced in the House. These bills address one of the most serious economic problems facing our country: our artificially inflated dollar.

Even with the intervention of the leading industrial nations, the dollar remains 20 to 30 percent inflated. Since 1980, our inflated dollar has already cost us two million manufacturing jobs and has seriously damaged the long term competitiveness of our industrial and agricultural sectors. The negative impact the high dollar is having on the international trading system is threatening future worldwide prosperity.

A hands off attitude toward currency relationships is no longer in our national interest. This clearly was the message acknowledged by the Reagan Administration at its September 22nd meeting with the other G-5 nations. For the past three days, leading political and economic thinkers have come together here in a privately funded conference in search of a new direction for the international monetary system, participants in that conference realize the present system is flawed and is hurting the international trading system.

Our economy is growing more interdependent every day. Three quarters of the goods and services produced in the United States are in competition with foreign made products or services. Greater coordination on fundamental economic policies between the major industrialized countries of the world will be needed, and greater consensus on exchange rate policies will be required, to keep our international trading system fair and growing.

Our trading partners are concerned. The actions by the Japanese since the G-5 initiative to intervene in capital markets to strengthen the yen against the dollar demonstrate this concern. It also demonstrates the progress which can be made through coordinated intervention to influence the market trends. The Bank of Japan has a $27 Billion reserve which it is actively using to influence currency patterns.

We are going to need both short term and long term actions to bring the dollar down to a more acceptable level and stabilize it. The two bills pending before you today are specifically designed to provide a framework to achieve these goals.

H.R. 3498, calls for the use of unsterilized intervention in the international currency markets when the U.S. current account deficit exceeds 1.5% of G.N.P., or about $50 Billion for four consecutive quarters, and when the dollar is at least 15% inflated on a trade-weighted basis. The foreign currencies purchased through these actions would be placed in a Strategic Capital Reserve in the

Department of Treasury. These reserves will not replace existing U.S. reserves held in the economic stabilization fund and elsewhere, but rather will be supplemental resources to be used to stabilize dollar movements in the future. H.R. 3498 is meant to be a short term tool for gradually reducing the value of the dollar and a standby safety mechanism for stabilizing it at a more appropriate level over the longer term.

It is important to use the intervention tool called for in H.R. 3498 strategically and effectively until a mechanism can be developed to better relate, with our trading partners, to the overall international monetary system. Achieving this latter goal is the primary purpose of H.R. 3573. H.R. 3573 calls for an international monetary conference. It is aimed at two things: First, at promoting long term convergence in economic policies between the United States and its allies and; Second, at achieving a consensus about long term reform of the international monetary system.

H.R. 3573 states that the Congress will not provide the President the authority to move forward with another round of G.A.T.T. negotiations until he also moves forward with a conference on international monetary reform. I support a new GATT round. But I also believe that we must tell the world that we believe development of a fair exchange rate system is as important as negotiations dealing with trade barriers. To proceed with another GATT round and devote all of our trade resources at this time to this effort without also moving on the monetary front is like stepping on an accelerator while using the brake at the same time. GATT talks cannot liberalize trade while monetary imbalances are retarding it.

These bills are no substitute for U.S. budget deficit reduction. Any action which this committee takes on these bills in the future should make this point very clear. Without deficit reduction, currency reduction achieved through intervention in the international currency markets is not sustainable. Furthermore, reduction of the U.S. budget deficit is a key ingredient in insuring longer term stability for the international monetary system.

There are compelling reasons to take action on the dollar even as we struggle to reduce our budget deficit. This year, the United States became a net debtor country for the first time since 1914. We imported $100 Billion of foreign capital last year. Within five years -- the timeframe which we are now talking about for achieving a balanced budget -- we will need nearly $100 Billion just to pay the interest on our foreign borrowings. Just as U.S. bankers are now cautious about throwing good money after bad into Latin America, if present trends continue foreign investors will soon look at our ballooning foreign debt and simply stop lending us enough money to keep our economy growing.

H.R. 3498 takes specific care to insure that actions to intervene in the currency markets do not hinder the availability of domestic credit or raise interest rates. Most times in the past, when currency intervention has been used it has resulted in increases in real interest rates because it has been sterilized, or offset, by tightening domestic credit. Unsterilized intervention, as the bill proposes, essentially creates credit so that it is unlikely to have a negative effect on interest rates or cause a domestic credit crunch. In fact, real interest rates will probably fall using unsterilized intervention. Therefore, utilizing the type of intervention called for under this bill should not unduly damage critical sectors of our economy like housing and construction.

We all know that credit expansion carries with it an inflationary risk. We all must be concerned about this. The provisions of H.R. 3494 call for a modest expansion of credit -- a minimum of $12 Billion over four quarters. This year, the Federal Reserve has loosened credit by more than that amount without reigniting inflation. The inflationary pressure accompanying this bill will be counterbalanced by other factors such as current excess productive capacity, persistent high unemployment, downward pressure on commodity prices, and the fact that during the past five years the psychology of inflation has been broken. In the final analysis, I believe the economic gains associated with a fair and stable exchange rate system outweigh the short term inflationary cost associated with these proposals.

Gradually bringing the value of the dollar down will help us learn once again how to live within our means. Unless we act to get our currency on a sustained and gradual decline. our currency will eventually come crashing down upon us, shooting up interest rates and throwing our economy into a deep recession. The most tramatic effect on the availability of domestic credit will accrue if we must go cold turkey off our unhealthy addiction to foreign capital. It will be much better for our economy to ease off this dependence gradually.

We must reduce our trade deficit. The record $150 Billion trade defict we will experience this year is acting as a drag on U.S. economic growth. If we do not act to reduce it, it will carry us right into a recession. If we ease the dollar down gradually, the competitiveness of our traded goods sector should improve gradually and help stimulate economic growth.

The effect of a falling dollar on U.S. trade is evident. Last week because of the fall of the dollar against the yen, Japanese firms began to worry about their competitiveness in the U.S. market. Acting over the short term to reduce the dollar is the most responsible way of reducing this trade deficit. How long do you believe we can sustain $150 Billion trade deficits? Can we afford to loose another two million manufacturing jobs and to continue to do long term harm to our agricultural, mining, and petrochemical sectors?

Theoretical economics says that as the U.S. trade balance increased, the value of the dollar should have fallen. This did not happen and as a result the U.S. will experience a record $150 billion trade deficit this year and probably end the year with a currency still twenty to thirty percent inflated. Theoretical economics did not account for the $20 Trillion in capital flows around the world annually and the impact that was to have on the trading system. For this reason, we need the reform called for in H.R. 3573 to address the tremendous distortions being caused by international capital flows.

I do not believe it would be healthy or possible to return to a fixed rate international system. But, when exchange rates were fixed, the volume of world trade grew by 7.5% a year. Since the floating rate system was put in place world trade has grown by only 3.3% a year. Protectionist sentiment is at its highest since the 1930s. Exchange rates do affect international trade flows. When they are seriously misaligned, as they are today, the world trading system suffers. In my judgement, it is time to assert some control over exchange rate patterns.

We must find some moderate postition between the rigidities of the fixed rate system and the volatility, uncertainty, and instability of the floating rate system. The President of the United States should lead the world toward a new consensus in this area. This is why we need an international monetary conference.

When the world was under a system of fixed exchange rates we had a self-enforcing discipline, and countries had to make a commitment to defend their exchange rates. While it often did not function as intended, it did make it much more difficult for countries to pursue their domestic economic objectives without regard to their trading partners.

Theorists and practictioners alike expected that the floating exchange rate system would enable countries to maintain a rough balance in their international trade accounts while still affording them the flexibility to pursue domestic economic objectives. They were wrong. What they failed to perceive adequately was the very large and independent role that capital flows would play in determining exchange rates, the negative impact that it would have on trade accounts, and the degree of speculation that would occur in international capital markets.

For the purposes of describing to you what these bills are and what they are not, let's for a moment assume that they were law when President Reagan took office in 1980. The forces which were driving capital to U.S. shores -- namely high real interest rates, the stimulus to U.S. economic growth provided by the combination of Reagan tax cuts and defense increases, the growing concern and eventual crisis over Latin American debt, and the sluggish growth of our foreign trading partners -- would have been unaffected. The dollar still would probably have strengthened over the Carter Administration levels.

Two things would have been different. First, under the provisions of H.R. 3498, when the current account deficit started ballooning in 1984 and the dollar was thirty to forty percent overvalued, the United States would have been required under law to intervene to keep the dollar from going higher and to try to put a break on the trade deficit. Second, under H.R. 3573, the President would have already taken steps to initiate reform of the monetary system and would have made several reports to the Congress on the progress of that effort.

These two bills try to articulate to the world a U.S. policy on exchange rates. The message they send is that we stand for reasonable and stable rates and that we are willing to work with our trading partners to achieve that balance. They send a signal to the world that we are prepared to come to the international conference table to seriously examine how we can better coordinate policies with our trading partners to achieve international economic growth through a healthier trading system.

We in the Congress must do our part to articulate a policy to deal with the problem of the overvalued dollar. We are not powerless to act. We can now go forward to build on the G-5 initiative to insure that the progress which has been made since the G-5 is real and lasting progress toward a fair and meaningful set of currency relationships for all concerned.

The Strategic Reserve called for in H.R. 3498 can help equip the United States with what is needed to better deal with the rocky course ahead of us. H.R. 3573 will provide the initiative to reform the system to insure only a limited use of those reserves.

Important progress has been made since the G-5 accord, but it must be followed up by sustained actions. Devising a system which insures greater coordination and action on macroeconomic policy by the major countries of the world cannot be achieved without clear policy articulation by the U.S. and long term reform of our current floating rate system.

Chairman **Neal**. Thank you, Congressmen Lundine, very much for your testimony. As I said, we are going to go ahead. We have another day's hearing scheduled, and we will go to a markup process. Again, I hope we don't take this approach, but if it is the will of the subcommittee, we certainly will. We are not going to drag our feet on it. We are going to go right ahead with it,and I thank you again for your help with this important subject.

At this time we would like to hear from Prof. William Poole of Brown University, a former member of the Council of Economic Advisers.

STATEMENT OF WILLIAM POOLE, PROFESSOR OF ECONOMICS, BROWN UNIVERSITY, AND FORMER MEMBER OF THE COUNCIL OF ECONOMIC ADVISERS

Mr. **Poole**. Thank you. I know from past experience that poor mortal professors have the same privilege as colleagues here in the Congress in terms of having the complete document printed for the record. I will read parts of my statement.

Chairman **Neal**. We will put your entire statement in the record. Thank you, sir.

Mr. **Poole**. I am very pleased to have this opportunity to testify on these two bills. My theme is a simple one. With all of our concerns, some of which are valid and some not, about the high dollar and the international current account deficit, let us not take actions that harm ourselves and the world economy.

In analyzing the two bills before us and the four questions put to me by Chairman Neal in his letter of invitation to testify at these hearings I will concentrate on issues of pure economics.

I take as given that there is a trade problem that the Congress must address. All of us accept the purposes laid out in these two bills, to stabilize exchange rates and improve the functioning of the international financial and trading system.

The issue, though, is whether various proposed actions are likely to be constructive—to have positive effects on trade that outweigh their negative effects elsewhere. In addressing the problem it is important that Congress keep open the option of doing nothing, as hard as that may be, rather than doing something harmful.

Let me begin with an analysis of H.R. 3498. The most important provision of this bill is the requirement in section 3 that each quarter the Federal Reserve and Treasury purchase foreign currencies in an amount between $3 billion and the value of the current account deficit during the previous quarter.

Under sections 4 and 5 purchases of foreign currencies are not to be offset by sales of foreign currencies or changes in domestic monetary policies. The net effect would be an increase in the annual rate of the U.S. money growth between roughly 5 and 40 percentage points depending on whether foreign exchange purposes were at the minimum or maximum required by the bill.

The first thing to be said about this bill is that it would indeed have the desired effect of causing a decline in the value of the dollar. However, it would do so by causing higher inflation in the United States. The entire economy would be destabilized. While the dollar would be lower, it would be unstable because the U.S. economy would be unstable.

The provisions in sections 4 and 5 apparently recognize that sterilized intervention in the foreign exchange market has little effect. Sterilized intervention occurs when a central bank buys foreign currencies and simultaneously sells domestic securities, or vice versa.

Whenever a central bank purchases anything it pays with a check written on itself. Such a check directly increases the Nation's money stock. With sterilized intervention, money-creating purchases of foreign exchange are precisely offset by money-destroying sales of domestic securities.

It is a widely-accepted proposition that sterilized intervention has little or no effect on the exchange rate. Even economists who do not accept this proposition agree that the effects of unsterilized intervention are quite different.

Unsterilized intervention involves a fundamental change in monetary policy. Economists argue over the effects of changes in monetary policy, but we agree that these arguments depend little or not at all on whether money growth changes because of purchases or sales of foreign currencies or domestic securities. It is useful to view an unsterilized intervention as a combination of a sterilized intervention and a conventional central bank open market operation in domestic securities.

The table on page 3 of my prepared statement illustrates this point using an example involving an intervention of $3 billion. On the left-hand side of this equation we have the central bank buying $3 billion of foreign currency, and that can be viewed as the sum of a sterilized intervention where we buy $3 billion of foreign currency and sell $3 billion of domestic bonds, and a monetary policy change that involves a $3 billion purchase of domestic bonds.

Under the premise that sterilized intervention has no effect—the premise underlying H.R. 3498—a directive that the Federal Reserve engage in unsterilized purchases of foreign exchange is the same as a directive that the Federal Reserve buy domestic bonds. With identical effect, therefore, section 3 could have directed the Federal Reserve each quarter to finance the Federal budget deficit by creating extra new money in an amount not less than $3 billion and not more than the value of the current account deficit the previous quarter.

I do not believe that anyone in the Congress would ever offer a bill directing the Federal Reserve to finance part of the Federal budget deficit by printing new money. It is widely understood by the American public that rolling the printing presses to finance Government spending is a ruinous practice. I assume, therefore, that those who support H.R. 3498 made a simple mistake because they did not realize that directing the Federal Reserve to engage in unsterilized foreign currency purchases is equivalent to directing the Fed to finance the Federal deficit by printing money.

I hope it is clear from these comments that I oppose H.R. 3498 on its merits and not because I object to all efforts to reduce Federal Reserve independence.

In fact, I have long been an advocate of greater congressional control over monetary policy. An often neglected fact is that when the Federal Reserve was established its monetary powers were constrained by the gold standard, which was established by law. Now that the gold standard is gone, the Congress should establish a new constraint on the monetary powers of the Federal Reserve.

I myself would be happy to work with Senator Bradley, Congressman Lundine and the appropriate congressional committees, to design a legislative directive to the Federal Reserve, but I believe as I have emphasized that the approach taken in this bill is unsatisfactory.

One of Chairman Neal's questions to me concerned the proper role of foreign exchange market intervention in monetary policy. Because it is my judgment that sterilized intervention has essentially no effect on the exchange rate, from a pure economics standpoint it is a matter of indifference whether monetary policy open market operations are conducted in U.S. Government securities or foreign currencies. Switzerland, for example, conducts almost all its open market operations in foreign currencies, and historically has had one of the most sound monetary policies in the world. A political issue of concern to me arises from the possibility of using general monetary policy to provide assistance to particular countries or firms or individuals that could not obtain assistance directly. Domestic open market operations need not be carried out in U.S. Government securities. The Federal Reserve could instead buy corporate bonds, State bonds, individual home mortgages, or even common stock. The Fed could buy stockpiles of strategic materials. Unless sterilized, the monetary effects of Fed purchases of any of these items are identical, and the same argument holds for purchases of foreign currencies. Permitting the Treasury and/or Federal Reserve to engage in open market operations in other than U.S. Government securities opens the door, de facto, to appropriations for specific countries, corporations, or individuals without the approval of Congress.

If I read the bill correctly, H.R. 3498 would permit the Treasury to buy any foreign currencies whatsoever. Purchases of a country's currency, subsequently invested in bonds issued by that country, are loans by the United States to the country involved. This bill, therefore, would give the administration the power to provide foreign aid to a particular country in excess of the amount agreed by Congress. Except insofar as economic analysis can help to make the point clear, this is not an economics issue. Speaking as a citizen, however, I hope that Congress will not give any administration, or the Federal Reserve, the power to appropriate taxpayer funds in this way.

Let me now turn to H.R. 3573. In my view this bill is based to a considerable extent on false premises, as indicated by some of the findings in section 2(a). I do not have time to discuss all of the findings, but perhaps the fundamental issue is joined when the bill states flatly that "The high value of the dollar is not justified given today's competitive realities."

That view rests on too narrow an interpretation of competitive realities. United States manufacturing and agriculture have indeed suffered from intense foreign competition, but those two sectors do not comprise the whole of the U.S. economy.

The high dollar is striking evidence of the financial strength of the United States. Our financial institutions are borrowing from foreigners at one interest rate and lending to both foreign and U.S. firms at a higher rate. That is a profitable business; I don't know of anyone who ever ran into trouble borrowing at 8 percent and lending at 10 percent. The high dollar is justified by today's competitive realities, which include a strong economy and stable financial environment. The problem is that one industry's competitive success may be another industry's competitive problem. The buggy makers understood that same point when Henry Ford came along.

Everyone agrees that the proximate cause of the high dollar and the capital inflow to the United States is the high return available in the U.S. capital markets. There is considerable dispute, however, over the cause of this high return.

Chairman NEAL. Professor Poole, could you withhold just for a minute. We have a rollcall vote pending over on the floor, and I think we had better recess for about 10 minutes to vote. We will be right back.

Mr. POOLE. Surely.

Senator BRADLEY. Mr. Chairman, I will have to go at noon.

Chairman NEAL. We will get back just as soon as we can.

[Recess.]

Chairman NEAL. We will reconvene the subcommittee at this time.

Again I apologize to our fine witnesses for the delay, the interruption, but we couldn't help it.

Professor Poole, please continue.

Mr. POOLE. Everyone agrees that the proximate cause of the high dollar and the capital inflow to the United States is the high return available in U.S. capital markets. There is considerable dispute, however, over the cause of this high return. One view is that the high return is the result of the large Federal budget deficit, which has pushed up interest rates as the Treasury has sold bonds to finance the deficit.

I am partial to an alternative explanation that emphasizes the importance of changes in U.S. economic conditions that have improved the anticipated after-tax return to new business investment in plant and equipment in the United States. The improved climate for such investment has raised both the level of business investment and the level of interest rates.

Interest rates are high primarily because of an outward shift of the non-Government demand for funds rather than because of a contraction of the supply of funds. Although these two explanations are not mutually exclusive, is it important to form some opinion on the dominant force at work over the last few years.

The table on page 8 of my prepared statement provides some evidence on these issues. Columns 1 and 2 report the flow of saving available to the U.S. economy in recent years, and columns 3 and 4 report the disposition of that saving. In order to highlight the Federal budget deficit I have combined State and local government saving with private saving in column 1 rather than with Federal Government dissaving in column 4, as is often done in these tables.

Column 2 reports saving entering from abroad; this saving was negative for 1980-83, which means that the United States sent more saving abroad than came in from abroad.

These two sources of saving were used to finance private investment in the United States and the Federal budget deficit, as shown in columns 3 and 4.

My reading of the evidence is that the attractive investment climate in the United States has been responsible for the investment boom that followed the 1981-82 recession. This boom shows up very clearly in the table. Investment was depressed in 1981-82, as is typical of recessionary periods, but has risen very substantially above its 1980 level.

This outcome is inconsistent with the view that the high budget deficit has forced up interest rates and crowded out investment. Given the attractive investment climate in the United States, and given that many economies abroad became stagnant, or worse, after 1980, capital quite naturally flowed to the United States.

H.R. 3573 does not introduce any new policies to achieve its stated purpose, but in section 4 requires the President to convene an international conference on the international monetary system.

Besides the fact that the President cannot convene such a conference unless other governments are willing, it is unwise even to request that the President begin negotiations with other governments about holding a monetary conference until we have a firm idea about what the U.S. position ought to be. There is no consensus on these issues within the United States, or within the U.S. Government.

The Congress should be particularly sensitive to the call in this bill for improved "convergence" and "enhanced cooperation." Those words have a favorable ring to them, but what they would mean if incorporated in a new international treaty is either nothing or some loss of U.S. policy independence. It does not seem to me wise for Congress to pass legislation containing an implicit offer to give up a certain degree of control over U.S. fiscal and monetary policy without having a clear idea of what we would give up and what we would get in return.

Question 4 put to me by Chairman Neal concerns the G-5 dollar policy announced September 22 of this year.

The first thing to be said, and I say this by way of reporting and nothing more, is that the universal view among those with whom I have discussed this policy is that its primary purpose is the appearance of action for the sake of heading off protectionist sentiment in Congress. Most dismiss the action as having no real substance. I am not so sure.

A country's exchange rate is not a spirit floating freely in the other. It is not a ghost through which you can punch your fist with no one ever ever noticing. The G-5 announcement said nothing about fundamental policy changes. In fact, to maintain a lower dollar economic policies will have to be different either here, or abroad, or both.

The G-5 agreement will have no effect on U.S. fiscal policy. I have not heard any mention whatsoever of that agreement in the debates surrounding the present deadlock over the debt ceiling.

Monetary policy is a different matter. The general perception is that higher U.S. interest rates would attract capital from abroad and strengthen the dollar. Because the independent Federal Reserve is not in a position to undercut openly the President's policy in this matter, the Fed has been forced to pursue a policy capping interest rates for the time being. That is a very unfortuante situation, for circumstances may arise in which interest rates must be allowed to increase to check excessive money growth before it causes an acceleration of inflation.

Given that money growth is already dangerously high this year—a 12-percent annual rate so far—we would never have explicitly adopted a monetary policy of even higher money growth for the purpose of pushing the dollar down. Yet, strangely, we have willingly adopted an exchange rate policy that may require higher money growth. A peculiar thing about Washington is that it is often the case that the way to do something frontwards is to do it backwards.

The other members of the G-5 may have anticipated that lower interest rates in the United States would permit them to lower their own interest rates. It is not working out that way. From elementary monetary analysis it is easy to predict that the sales of dollars by foreign countries trying to push the dollar down through foreign exchange market intervention will tend to reduce their own money stocks.

Sterilized intervention would leave their money stocks unaffected, but would not hold the dollar down. Thus, the G-5 policy, which is inflationary for the United States, is deflationary abroad. If these deflationary policies choke off already low growth in Europe, which could well happen, they will make our trade deficit even worse as demand in our export markets softens.

Eventually deflation any policies in Europe and Japan will be abandoned. That would put even greater pressure on the United States to follow an inflationary policy to hold the dollar down.

In my opinion, the main uncertainty about the G-5 policy is whether it will serve its political purpose in time to be abandoned before creating an inflation problem in the United States. A judgment on this matter requires accurate economics and political crystal balls. I have neither.

Chairman NEAL. Professor, could I interrupt you just for a second. I am worried about the time here. I know Senator Bradley has to leave. Could we take a couple of minutes at this point before we get to your concluding remarks, for you all to, if you feel like it, comment about each other's testimony and maybe entertain a couple of questions from the subcommittee.

[The prepared statement of Mr. Poole follows:]

Statement of William Poole
Professor of Economics
Brown University

before the

SUBCOMMITTEE ON INTERNATIONAL FINANCE, TRADE AND MONETARY POLICY
of the
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

November 14, 1985

STATEMENT

I am very pleased to have the opportunity to testify at these hearings on H.R.3498 and H.R. 3573. My theme is a simple one: with all of our concerns, some valid and some not, over the high dollar and international current account deficit let us not take actions that harm ourselves and the world economy.

In analyzing the two bills before us and the four questions put to me by Chairman Neal in his letter of invitation to testify at these hearings I will concentrate on issues of pure economics. I take as given that there is a "trade problem" that the Congress must address. The issue is whether various proposed actions are likely to be constructive--to have positive effects on trade that outweigh their negative effects elsewhere. In addressing the problem it is important that Congress keep open the option of doing nothing rather than doing something harmful.

Analysis of H.R.3498

The stated purpose of H.R.3498 is, "to stabilize international currency markets in support of fair global competition." That is a goal we can all accept. But there are other goals we also accept such as full employment and price stability. These goals, and others, often conflict. The basic problem with H.R.3498 is that it would sacrifice price stability and, I believe, employment stability also, in its pursuit of a lower trade deficit.

The most important provision of this bill is the requirement in Section 3 that each quarter the Federal Reserve and Treasury purchase foreign currencies in an amount between $3 billion and the value of the current account deficit during the previous quarter. These purchases are to be made whenever the current account deficit exceeds 1.5 percent of GNP and the dollar is 15 percent or more above its equilibrium rate. Under Sections 4 and 5 of the bill purchases of foreign currencies are not to be offset by sales of foreign currencies or by changes in domestic monetary policy. The net effect would be an increase in U.S. money growth of between roughly 5 and 40 percentage points depending on whether foreign exchange purchases were at the minimum or maximum required by the bill.

This calculation is made as follows: An unsterilized purchase of foreign currencies of $12 billion in a year would raise the monetary base by a like amount. Twelve billion dollars is about 5 percent of the present monetary base of about $230 billion. Unsterilized intervention at the maximum rate permitted by this bill would raise the monetary base by $100 billion in a year, or about 40 percent. Finally, a given percentage increase of the monetary base will translate into an increase of the money stock of about the same percentage.

The first thing to be said about this bill is that it would indeed have the desired effect of causing a decline in the value of the dollar. However, it would do so by causing higher inflation in the United States. The entire economy would be destabilized. While the dollar would be lower, it would be unstable because the U.S. economy would be unstable.

The provisions in Sections 4 and 5 apparently recognize that sterilized intervention in the foreign exchange market has little effect. Sterilized intervention occurs when a central bank buys foreign currencies and simultaneously sells domestic securities, or vice versa. Whenever a central bank purchases anything it pays with a check written on itself. Such a check directly increases the nation's money stock. With sterilized intervention, money-creating purchases of foreign exchange are precisely offset by money-destroying sales of domestic securities.

It is a widely-accepted proposition that sterilized intervention has little or no effect on the exchange rate. Even economists who do not accept this proposition agree that the effects of unsterilized intervention are quite different. Unsterilized intervention involves a fundamental change in monetary policy. Economists argue over the effects of changes in monetary policy, but we agree that these arguments depend little or not at all on whether money growth changes because of purchases or sales of foreign currencies or domestic securities.

It is useful to view an unsterilized intervention as a combination of a sterilized intervention and a conventional central bank open market operation in domestic securities. The table below illustrates this point using an example involving an intervention of $3 billion.

Unsterilized Intervention	=	Sterilized Intervention	+	Monetary Policy Change
Buy $3 bil. of foreign currency	=	Buy $3 bil. of foreign currency and sell $3 bil. domestic bonds	+	Buy $3 bil. of domestic bonds

Under the premise that sterilized intervention has no effect--the premise underlying H.R.3498--a directive that the Federal Reserve engage in unsterilized purchases of foreign exchange is the same as a directive that the Federal Reserve buy domestic bonds. With identical effect, therefore, Section 3 could have directed the Federal Reserve each quarter to finance the Federal budget deficit by creating extra new money in an amount not less than $3 billion and not more than the value of the current account deficit the previous quarter.

I do not believe that anyone in the Congress would ever offer a bill directing the Federal Reserve to finance part of the Federal budget deficit by printing new money. It is widely understood by the American public that rolling the printing presses to finance government spending is a ruinous practice.

Every member of Congress knows that there are no votes to be gained and many to be lost by advocating patently irresponsible monetary policies. I assume, therefore, that those who support H.R. 3498 made a simple mistake because they did not realize that directing the Federal Reserve to engage in unsterilized foreign currency purchases is equivalent to directing the Fed to finance the Federal deficit by printing money.

I hope it is clear from these comments that I oppose H.R. 3498 on its merits and not because I object to all efforts to reduce Federal Reserve independence. In fact, I have long been an advocate of greater Congressional control over monetary policy. An often neglected fact is that when the Federal Reserve was established in 1913 its monetary powers were constrained by the gold standard, which was established by law. Now that the gold standard is gone Congress should establish a new constraint on the monetary powers of the Federal Reserve. It is healthy for us to study and debate legislative monetary policy directives, and in time I expect Congress will provide greater guidance to the Federal Reserve. But the approach taken in H.R.3498 is simply unsatisfactory.

One of Chairman Neal's questions to me concerned the proper role of foreign exchange market intervention in monetary policy. Because it is my judgment that sterilized intervention has essentially no effect on the exchange rate, from a pure economics standpoint it is a matter of indifference whether monetary policy open market operations are conducted in U.S. Government securities or foreign currencies. Switzerland, for example, conducts almost all its open market operations in foreign currencies, and historically has had one of the most sound monetary policies in the world. The primary economics issue concerns the potential for taxpayer losses from government speculation in foreign currencies.

Sterilized foreign exchange market intervention raises two types of political issues. The first concerns the possibility that intervention may end up not being sterilized. Monetary issues are complicated, and acceptance of intervention may permit changes in monetary policy that could not be achieved openly and directly. If political experts, such as members of this committee, can assure me that there are no dangers here, then I will be happy to stick to economics and let others take care of the politics.

The second type of political issue arises from the possibility of using general monetary policy to provide assistance to particular countries or firms or individuals that could not obtain assistance directly. Domestic open market operations need not be carried out in U.S. Government securities. The Federal Reserve could instead buy corporate bonds, state bonds, individual home mortgages, or even common stock. The Fed could buy stockpiles of strategic materials. Unless sterilized, the monetary effects of Fed purchases of any of these items are identical, and the same argument holds for purchases of foreign currencies.

Permitting the Treasury and/or Federal Reserve to engage in open market operations in other than U.S. Government securities is opens the door to de facto appropriations for specific countries, corporations, or individuals without the approval of Congress. If I read the bill correctly, H.R.3498 would permit the Treasury to buy any foreign currencies whatsoever. Purchases of a country's currency, subsequently invested in bonds issued by that country, are loans by the United States to the country involved. This bill, therefore, would give the administration the power to provide foreign aid to a particular country in excess of the amount agreed by Congress. Except insofar as economic analysis can help to make the point clear, this is not an economics issue. Speaking as a citizen, however, I hope that

Congress will not give any administration, or the Federal Reserve, the power to appropriate taxpayer funds in this way.

Analysis of H.R.3573

The purpose of H.R.3573 is, "to achieve stable and reasonable exchange rates for international currencies to strengthen the international economy and provide for international economic growth." I accept these purposes, and applaud Congress in its efforts to improve the international financial system and strengthen the international economy.

In my view, however, H.R.3573 is based on false premises, as indicated by some of the findings in Section 2(a). It is unfortunate that the bill measures dollar appreciation from a 1980 base. It was widely agreed at that time that the dollar was undervalued on a purchasing power parity basis. By 1980 both U.S. and foreign investors had lost confidence in the U.S. economy, and especially in the prospects for price stability. Funds were flowing abroad to Switzerland, Germany, and Latin America as investors sought higher returns outside the United States. Using 1980 as a base for comparison seems to imply that we should attempt to restore the economic conditions of that year. I reject that view.

Second, the bill states flatly that, "the high value of the dollar is not justified given today's competitive realities...." That view rests on too narrow an interpretation of "competitive realities." U.S. manufacturing and agriculture have indeed suffered from intense foreign competition, but those two sectors do not comprise the whole of the U.S. economy. The high dollar is striking evidence of the financial strength of the United States. Our financial institutions are borrowing from foreigners at one interest rate and lending to both foreign and U.S. firms at a higher rate. That is a profitable business; I don't know of anyone who ever ran into trouble borrowing at 8 percent and lending at 10 percent. The high dollar is justified by today's competitive realities, which include a strong economy and stable financial environment. The problem is that one industry's competitive success may be another industry's competitive problem. The buggy makers understood that same point when Henry Ford came along.

Despite the fact that the economic expansion after the 1982 recession involved an enormous growth of employment in the United States, and the fact that the unemployment rate today is about the same as in 1980, H.R.3573 asserts that,"[the] trade deficit has resulted in the loss of over 2 million jobs...." Manufacturing employment has declined by about 1 million since 1980, but most of those workers have found jobs elsewhere. Total employment is now more than 8 million above its 1980 average.

Almost everyone agrees that the proximate cause of the high dollar and the capital inflow to the United States is the high return available in the U.S. capital markets. There is considerable dispute, however, over the cause of this high return. One view is that the high return is the result of the large Federal budget deficit, which has pushed up interest rates as the Treasury has sold bonds to finance the deficit.

I am partial to an alternative explanation that emphasizes the importance of changes in U.S. economic conditions that have improved the anticipated after-tax return to new business investment in plant and equipment. The improved climate for such investment has raised both the level of business investment and the level of interest rates. Interest rates are high primarily because of an outward shift of the non-government demand for funds rather than because of a contraction of the supply of funds. Although these two explanations are not mutually exclusive, is it important to form some opinion on the dominant force at work over the last few years.

The table below provides some evidence on these issues. Columns (1) and (2) report the flow of saving available to the U.S. economy in recent years, and columns (3) and (4) report the disposition of that saving. In order to highlight the Federal budget deficit I have combined state and local government saving with private saving in column (1) rather than with Federal Government dissaving in column (4). Column (2) reports saving entering from abroad; this saving was negative for 1980-83, which means that the U.S. sent more saving abroad than came in from abroad. These two sources of saving were used to finance private investment in the United Stater and the Federal budget deficit, as shown in columns (3) and (4).

SAVING AND INVESTMENT FLOWS, 1980-85
National Income and Product Accounts Basis
(Percent of GNP)

Year	(1) Private plus S&L Govt. Saving	(2) International Capital Inflow	(3) Gross Private Domestic Invest.	(4) Federal Deficit
1980	18.5	-0.9	15.3	2.3
1981	19.5	-0.9	16.4	2.2
1982	19.0	-0.6	13.5	4.8
1983	19.4	0.3	14.3	5.4
1984	20.5	1.8	17.4	4.8
1985*	19.6	2.2	16.8	4.9

* First half

My reading of the evidence is that the attractive investment climate in the United States has been responsible for the investment boom that followed the 1981-82 recession. This boom shows up very clearly in the table. Investment was depressed in 1981-82, as is typical of recessionary periods, but has risen very substantially above its 1980 level. This outcome is inconsistent with the view that the high budget deficit has forced up interest rates and crowded out investment. Given the attractive investment climate in the United States, and given that many economies abroad became stagnant--or worse--after 1980, capital quite naturally flowed to the United States.

If the Federal budget deficit had been smaller our investment performance might have been even better, provided that the methods used to achieve a smaller deficit had not injured the investment climate. For example, heavy taxes on business might have reduced the budget deficit, but also have simultaneously reduced investment, the value of the dollar, the capital inflow, and total employment.

H.R. 3573 does not introduce any new policies to achieve its stated purposes, but in Section 4 requires the President to convene an international conference on the international monetary system. Besides the fact that the President cannot convene such a conference unless other governments are willing, it is unwise even to request that the President begin negotiations with other governments about holding a monetary conference until we have a firm idea about what the U.S. position ought to be. There is no consensus on these issues within the United States, or within the U.S. Government.

Congress should be particularly sensitive to the call in this bill for improved "convergence" and "enhanced cooperation." Those words have a favorable ring to them, but what they would mean if incorporated in a new international treaty is either nothing or some loss of U.S. policy independence. It does not seem to me wise for Congress to pass legislation containing an implicit offer to give up a certain degree of control over U.S. fiscal and monetary policy without having a clear idea of what we would give up and what we would get in return.

Because exchange rate, trade, and macro policy issues are so important, and because we will not determine the feasible and desirable limits to further policy coordination and cooperation without additional study, let me suggest an alternative to an international monetary conference at this time. My suggestion is that the United States request the various working parties and committees of the Organization for Economic Cooperation and Development (OECD) to study all aspects of these issues. The twenty four advanced industrial nations that comprise the OECD membership are central to any proposal for world monetary reform, and that organization is well-suited to conduct the required studies.

I was, quite frankly, surprised when I read Section 4(c) of H.R.3573. That section would prevent the President from commencing GATT negotiations to reduce or eliminate tariff and non-tariff trade barriers. My surprise stemmed from the fact that it is generally recognized that trade barriers abroad are more serious impediments to trade than are our own barriers. Although we do have some serious trade barriers, almost all of which I regard as regrettable, the tremendous increase of U.S. imports in recent years shows that our trade restrictions are generally not very great.

U.S. exporters have much more to gain from reducing barriers abroad than U.S. firms competing with imports have to lose. We might almost say that what our import-competing firms have to lose they have already lost. If we have the trade problem that the sponsors of the bill think we have, why do they want to prevent the President from entering into negotiations to reduce trade barriers abroad? That would surely be the practical effect of this provision over the next few years given that the President cannot convene a monetary conference without adequate preparation and without the cooperation of foreign governments.

The G-5 Dollar Policy

Question 4 put to me by Chairman Neal concerns the G-5 dollar policy announced September 22 of this year.

The first thing to be said--and I say this by way of reporting and nothing more--is that the universal view among those with whom I have discussed this policy is that its primary purpose is the appearance of action for the sake of heading off protectionist sentiment in Congress. Most dismiss the action as having no real substance. I am not so sure.

A country's exchange rate is not a spirit floating freely in the ether. It is not a ghost through which you can punch your fist with no one ever noticing. The G-5 announcement said nothing about fundamental policy changes. In fact, to maintain a lower dollar economic policies will have to be different either here, or abroad, or both.

The G-5 agreement will have no effect on U.S. fiscal policy. I have not heard any mention whatsoever of that agreement in the debates surrounding the present deadlock over the debt ceiling.

Monetary policy is a different matter. The general perception is that higher U.S. interest rates would attract capital from abroad and strengthen the dollar. Because the independent Federal Reserve is not in a position to undercut openly the President's policy in this matter, the Fed has been forced to pursue a policy capping interest rates for the time being. That is a very unfortunate situation, for circumstances may arise in which interest rates must be allowed to increase to check excessive money growth before it causes an acceleration of inflation.

Given that money growth is already dangerously high this year--a 12 percent annual rate so far--we would never have explicitly adopted a monetary policy of even higher money growth for the purpose of pushing the dollar down. Yet, strangely, we have willingly adopted an exchange rate policy that may require higher money growth. A peculiar thing about Washington is that it is often the case that the way to do something frontwards is to do it backwards.

The other members of the G-5 may have anticipated that lower interest rates in the United States would permit them to lower their own interest rates. It is not working out that way. From elementary monetary analysis it is easy to predict that the sales of dollars by foreign countries trying to push the dollar down through foreign exchange market intervention will tend to reduce their own money stocks. Sterilized intervention would leave their money stocks unaffected, but would not hold the dollar down. Thus, the G-5 policy, which is inflationary for the United States, is deflationary abroad.

If these deflationary policies choke off already low growth in Europe, which could well happen, they will make our trade deficit even worse as demand in our export markets softens. Eventually, deflationary policies in Europe and Japan will be abandoned. That will put even greater pressure on the United States to follow an inflationary policy to hold the dollar down.

In my opinion, the main uncertainty about the G-5 policy is whether it will serve its political purpose in time to be abandoned before creating an inflation problem in the United States. A judgment on this matter requires accurate economics and political crystal balls. I have neither.

What Should be Done About the Strong Dollar?

Chairman Neal's second question to me, which I have saved for last, is what, if anything, we should do about the strong dollar. As I have made clear above, my view is that the strong dollar is fundamentally the result of improved economic fundamentals in the United States and weaker fundamentals abroad. In the United States, inflation is down, employment is up, investment is strong, and people are generally optimistic about the future.

The contrast between our economic conditions and those in most countries abroad is striking. Bill Niskanen, my former colleague on the CEA, has put it this way: the United States has its problems but we should not want to trade them for those of any other country in the world. Our aim should be a lower dollar as a result of improved fundamentals abroad. We can encourage other nations to pursue better policies, both by example and in other ways, but cannot control the outcome.

Of our problems, by far the most serious is the Federal budget deficit. Because the deficit is unsustainably large, it will not be sustained. The issue is how the deficit will be reduced. One possibility is that we will inflate it away, or partly away, with disastrous consequences for the U.S. and world economies. No one, of course, will sit down and decide on an inflationary policy; we will fall into such a policy by default as we are unwilling, step by step, to pursue a monetary policy consistent with price stability. We have already given up talking about a complete return to a stable price level, and the G-5 dollar policy runs a substantial risk of higher inflation.

Another possibility is that we will attempt to close the deficit primarily through tax increases. Tax increases on business, which seem likely even if we get revenue-neutral tax legislation, will injure the investment climate in the United States. The result will be lower business investment, lower real interest rates, a lower dollar, lower employment growth, and higher inflation.

Tax reform should include a revision of the distribution of tax incentives for business investment but not a reduction of their average level. Deficit reduction should in my view be achieved entirely through spending reduction; but if Congress decides on tax increases they should fall on consumption and not on saving and investment. Taxing today's investment is the same thing as taxing tomorrow's consumption.

The bottom line is that a strong U.S economy makes our Nation attractive to foreigners as well as to our own citizens. Foreign investors want to move their capital here. People want to cross our borders, legally or illegally. Success creates problems. We know how to "cure" those problems; many unfortunate nations around the world have provided lessons on what policies to follow to encourage people and capital to move away. My fear is that in our concern over the "dollar problem" we will follow some of those same policies.

Chairman NEAL. Senator.

Senator BRADLEY. Mr. Chairman, let me try to address the question that you raised earlier. I am sure that is one of the cruxes of the matter.

Chairman NEAL. There are two main questions.

Senator BRADLEY. Yes, you want to know about inflation.

Chairman NEAL. Inflation is the big one, and the other one has to do with granting extra-territorial authority over our economy to some committee comprised of us and some other representatives of foreign countries. But the inflationary one I think is frankly the most pressing. I don't think we are going to do the second one anyway, but we have inflated our economy in the past, and I think it is very likely that we are going to do it again, even if we don't go into something like this.

Senator BRADLEY. I suppose my response to the inflation question is that you have a problem with the trade deficit. The exchange rate is the greater part of that problem. It is widely recognized that that is the case. Now what are you going to do anything about that? Are you going to try to do anything about it?

As the professor said, sterilized interventions don't really do anything. I would give him a little credit that on the margins some psychological expectations effects might occur; but they do not greatly alter net capital flows, and it seems to me that this committee and the Congress not only given the pressures of protectionism, although those are significant, but given the desire to restore competiveness to our industrial and agricultural sectors, would want to do something that would make American agriculture, American manufacturing and American mining, more competitive, so that we would stop losing jobs and sales abroad, so that we could remove the tax that is on all of those export items, and the subsidies that exist on imports that compete in those areas. To say you are going to do nothing is to acquiesce to yo-yo exchange rates and to a tax on our exports and subsidy to imports that compete with our products.

I believe it is a serious problem. In these last 2 days we had a lot of comments from people from around the world, and the British made a very telling comment. They said you know once you lose that industrial sector, once you lose the ability to compete abroad, it is not easy to regain it, and there is a degree of urgency here to do something.

All of this argues, I think, for unsterilized sale of currencies or purchase of foreign currencies in international markets.

Your question is, Is this inflationary? You have a balance here. What is worse? Is it worse to have a minimim of $12 billion, actually you could have less if the deficit dropped, sale of dollars, purchase of foreign securities, with the threat of inflation that that might entail, or is it worse to have a continued erosion of the industrial and agricultural sector because of the price of goods set by a value of the dollar that is too high, that is not competitive.

I would argue that you should err on the side of realigning the exchange rates, and this is the most effective way to do it, as Professor Poole testified.

It would succeed in getting the exchange rate down, as opposed to sterilized where he said it wouldn't just taking the number, last year the Federal Reserve created money, created $12.5 billion in the purchase of U.S. Government securities.

There is no reason why next year, if they chose to increase the money supply for domestic reasons, that they might chose to do that by purchasing foreign government securities in part or full.

Now what that amounts to is a back door sterilization. That is why you might want to do it in part and not in full.

I think that you have to ask youself the credibility question. The traders that I talk to said if you do sterilized intervention that is just Congress trying to stem protection with P.R. It is not credible. But I think if you did an unsterilized intervention, that it would be credible. It is hard for me to believe, as I look out at an economy that I think suffers from serious deflation, to argue that a $3 billion or $6 or a $9 or even a $12 billion increase in the money supply is going to bring back rampant inflation 18 to 24 months from now, because when I look out there I see an erosion of collateral value that is striking.

Land prices have plummeted, oil prices that have dropped, real estate prices that have dropped, and I see that as a major threat to our financial system, and to say that you are going to do nothing about it is I think jeopardizing our financial system and our economy, and I would argue therefore the down side risk on inflation is a managable and small.

If it did seem to create a problem the Federal Reserve would have the flexibility to respond, and I argue that it is much better for us to act to make American industry and agriculture more competitive than it is for us to worry about an increase in inflation, which could be minimized by a mix of purchases of U.S. Government securities and foreign currencies, and which given the deflationary circumstances in our economy I think are minimal.

Chairman NEAL. Let me say if I may in passing that even though I don't favor this approach, I also don't favor doing nothing. I mean my own preference would be to try to get our own domestic fiscal house in order, which I know is your goal also. You know my concern is that with this approach we could do some harm.

Professor, would you want to respond to these comments?

Mr. POOLE. I was going to make exactly the same point. I hope that my initial statement on that was not misunderstood. I don't think I advocated doing nothing. I said, let's be very sure that what we do is better than doing nothing.

If it is not better than doing nothing we should do nothing, but we need to look at the options that may be on the table. I just don't think that these options are better than doing nothing.

Senator BRADLEY. But I would like, if I could, to ask what is the option then? I argue that this will reduce the value of the dollar, make American industry more competitive, make agriculture more competitive, that it has a minimal downside inflationary risk, and the strength of the financial system is at stake. What is the alernative?

Mr. POOLE. First of all, I think that you have greatly exaggerated the problem. Just looking in the economic indicators table on industrial production, the fact is that industrial production over a very wide range of products is well above what it used to be. Manufacturing is not clobbered to the extent that you have implied.

Total employment in manufacturing is about one million less than was the case in 1980, if we are going to use 1980 as the base year. We may argue about that.

Senator **Bradley**. I think we would.

Mr. **Poole**. That has been used as the base year. But manufacturing output is up in most industries, and you can go across the table of industrial production in the various categories, and one after another, the main ones that are down are iron and steel. We know that the iron and steel and related industries have a lot of problems.

Apparel is actually about flat total, despite the tremendous problems in that industry. And among the other industrial categories many are up very, very substantially.

Senator **Bradley**. Mr. Chairman, he says there isn't a problem.

Chairman **Neal**. Mr. Lundine.

Mr. **Lundine**. I didn't want to interject here because my colleague, Mr. Bradley, has to leave and I don't, and I am going to be here to hound you. If you do nothing I am going to remind you you did nothing and you are going to be held accountable for doing nothing.

Mr. **Leach**. Is that an inter-Democratic party threat?

Mr. **Lundine**. No; it is not a threat, it is a bipartisan promise. I can't help but quote Professor Poole earlier when he said "manufacturing and agriculture are not the whole of the U.S. economy." If you think we can get along with a stagnant or deflated agriculture and manufacturing base, fine, do nothing, or at the best get our fiscal house in order over 5 years.

I mean if you had a plan to balance the budget in 2 years, I would be listening, but we are struggling with whether over 5 years we can get the budget in balance.

Now can this exchange rate imbalance wait 5 years? I would like to look at it a little differently. Let's just look at some statistics on import penetration. Consumer electronics, 47.6 percent in 1976, 60.7 percent in 1984. Machine tools 15.4 percent in 1976, 38.5 percent in 1974. Shoes, 47 percent. Automobiles, 14 percent, 23 percent. Or you could take a different criteria. Take our share of the world market.

The decline in 7 out of 10 high technology industries, 13 out of 14 standard industrial changes. I think this problem of deflation on the farm is obvious, and the farm credit system is in serious trouble as a result of it. The problem in manufacturing is only slightly behind it in my judgment.

Senator **Bradley**. The Federal Reserve has the responsibility internally as an arbiter of internal demand.

It also has an external responsibility which is the exchange rate responsibility, and ultimately given the nature of the financial system it is a kind of lender of last resort worldwide. They wouldn't agree to that, but that is how I would characterize it.

The political process—meaning Congress—has taken what I would consider some imprudent steps toward direct involvement with Federal Reserve internal policies, monetary policies affecting internal economic decisions of the United States. Given this, I believe it is legitimate for us to look equally at Federal Reserve external policy, and this country comes to this realization late. As politicians, we are confronting it for the first time. Members of this committee, I believe, are no doubt light years ahead of many other Congress people or Senators, because we have not viewed ourselves as an international economy.

We have viewed ourselves as a domestic economy that occasionally engaged in trade and screamed when imports got too high. If we look at our future as a Nation, it lies with successful competition in a stable and growing world economy, developing markets in the Far East or Latin America and we are going to have to begin to realize that domestic economic decisions that we take have international repercussions, and we should think about those international repercussions before we make domestic decisions. Or once the domestic decisions are taken—and I would argue an example of such decisionmaking was trying to finance the Federal deficit in 1982 with high interest rates, figuring it was going to be free, and ending up with a Third World debt crisis that produced capital flows that inflated the value of the dollar, and resulting in industrial, agricultural and the mining sectors in serious trouble—we should at least recognize there is a problem, we should act, and we should act by trying to make our currency more competitive. To say that you are not going to do so because you have a fear of a resurgence of inflation, given the deflationary circumstances that are out there today, would not be realistic or in the best long-term interest of the country.

Chairman **Neal**. Let me make just one other point on this subject that we haven't really touched on. That is, you know the market in currencies is an international one that works around the clock around the world, and it is immense in size. Hundreds of billions of dollars of currency are traded. There are days when over $100 billion of currency is traded, and the idea that you are going to be able to manipulate that with $12 billion in any effective sense I think is unrealistic.

You can point to the recent experience where we announced this program in cooperation with others and the dollar fell against some other currencies, but some economists will tell us that, yes, those that trade in the currencies were concerned about that. They didn't know the extent to which we would be intervening, or other countries would, and held back and didn't trade as much. But I guess what I am trying to say is that to be effective would require many more billions of dollars than we are talking about here, for the long term.

You can jump in, but there are other options. Stan and I had a meeting with an economist not long ago where he pointed out if you are going with a trend, that you might be able to nudge it along a little bit. But you are not really changing anything fundamental, and it is probably, this fellow said who is in favor, if I understood him correctly, that you really can't be successful when you are bucking the trend.

Senator **Bradley**. If I could just respond to that as best I could. I think it is a little difficult to argue that this kind of intervention will produce serious inflationary problems on the one hand, and then argue that it is so moderate that it will have no impact on the exchange rate.

Chairman Neal. That wouldn't be my argument. I would argue that the inflationary impact would come in, you commit enough to be effective. That is where the problem will come. I couldn't tell you $12 billion. I don't have any magic answer percentagewise.

Senator Bradley. So you don't fear the inflation from the $12 billion?

Chairman Neal. I don't know. I would have to look at that. I haven't looked at that specific figure, but I fear inflation when the rate of money grows much faster than the economy is growing at any point, whatever that is.

Senator Bradley. Yes; now that is in total control of the Federal Reserve.

Chairman Neal. That is right.

Senator Bradley. If you look at floating exchange rates, for floating exchange rates to have balanced the current account deficit in 1984, under this kind of proposal, you would have to have sold nearly $100 billion. This proposal only requires the Fed to sell a minimum of $12 billion.

Chairman Neal. Then I would argue that that probably wouldn't be effective.

Senator Bradley. Let me come to that. I would like to make the point again that I don't think that that amount is going to be inflationary. Why is moderate intervention enough? Consider first that of the transactions in the world currency markets every day of $150 billion, a large proportion are transactions that are made to finance trade.

People who need yen, people who need dollars, who need to finance trade. Now, a lot of those transactions are bank settlements. The same accounts sweep four of five transactions in a day that total up. You might sell the same instrument five times, and it totals five times the size of the instrument. So what I think you are aiming for is not to stem the tide of $150 billion a day, but to affect the traders' perception of that margin between demand and supply, and I would argue that that would be much smaller, much smaller than most imagine.

The reason we picked $12 billion was that in consulting with a number of economists around the country, we heard $12 billion is the minimum to have an impact, and we chose the minimum to see that we would minimize the inflationary potential. Maybe that is not enough, although I would argue that it is, because you are really dealing with affecting only the margin.

I argue that it is Government's role to try to nudge the trends. Speculators, I believe, follow the trend. They don't make the trend. And as soon as they see intervention, they carry it in the right direction, and I think that the result will be a more competitive dollar and a much better trade performance on the current account.

Mr. Lundine. May I make just one comment?

Chairman Neal. Please.

Mr. Lundine. There is a lot of empirical evidence this year to suggest that the intervention makes a difference. Most recently it has really been the Japanese or the G-5 countries that have put their money where their mouth is, so to speak, and they have been in the markets a couple of times with $3 or $4 billion, and the yen has in fact depreciated from around 240 to 207 or thereabouts in relation to the dollar.

Earlier this year, at the hint of intervention, the dollar eased down. This summer when Volcker came up here and unfortunately said he was concerned about it, and immediately the markets reacted, and that fall was abated.

Finally, let me say that earlier this year, in order to understand this whole system and how it works, I talked to an awful lot of people and read a lot, and I talked to a Swiss banker. This is just an interesting point, how speculative it is, and to support Bill's point, that the traders don't start markets, they follow markets.

This fellow kept telling me he was making money in dollars, and he was keeping his people in dollars, but only for a short time. I said, "Well, aren't you worried about our trade deficit and our budget deficit?"

"Oh, yes," the Swiss banker said, he was very worried about it, but he was keeping it in short term, and he said, "I want to ride the dollar out until it begins to fall, and then I'll get out of it immediately."

To me the language he used was like a bettor at Las Vegas or Atlantic City more than a banker. I think it illustrates the point that these people are looking for signals, and we are dealing in intervention at the margin, not this huge swamp of currency that goes back and forth every day anyway, and I really think empirical evidence suggests that it can make a difference.

Chairman NEAL. Mr. Leach.

Mr. LEACH. It strikes me, Stan, that both you and Bill have a good handle on the problem. I am hard pressed to think you have a solution. In fact, I am reminded of the immortal words of Grantland Rice, it is not whether you win or lose but on whom you place the blame.

What you have got is much ado about something and the point of the chairman is not insignificant. You are talking about $3 billion a quarter. You are also talking about signaling, just when you expect to put in $3 billion. Furthermore, the $3 billion isn't a commitment to change. It is just simply a commitment to purchase foreign currencies. It is just an arbitrary commitment to put it in.

When that money is put in, you are putting the U.S. Government exactly in the role of a speculator. If you do well, you make money, and if you don't you lose. One of the disadvantages of signaling well in advance is that everyone knows it is coming. One of the advantages of doing it without warning is that you have a better chance of making money. Your approach is one almost designed to increase the prospect of losing money in intervention rather than making it. That is going to be real tough on the taxpayer.

I just have tremendous doubts. I think what you have here is a bill that will present Presidential candidates with great things to talk about. I hope you are one, William. I think the Democratic Party couldn't do better, and I think it would be great for the country, but I am not at all sure that this bill that doesn't provide a little bit of false optimism.

If we have a given Federal trade deficit, are we better off putting $3 billion in buying foreign securities or are we better off reducing the deficit $3 billion. You tell me which is——

Mr. LUNDINE. You are better off doing both.

Mr. LEACH. Well, of course, but let me just say we are the Congress of the United States of America. We are responsible primarily for fiscal policy, although it is certainly true that monetary authorities report to the Congress, and the Fed is a creature of the Congress, but I think we are playing kind of a populist game in saying it is defensible for the deficit environment. Aren't we kind of shirking our own responsibilities here by suggesting, I think a little mischievously, that we are going to be able to change international money supply based upon this minimalist approach?

Senator BRADLEY. If I could respond. Thank you, first of all——

Mr. LEACH. It is an endorsement of the opposition.

Chairman NEAL. If this will help, I might have to change my position.

Senator BRADLEY. Obviously I don't think that this is the answer to all of our economic problems. I mean, if I am to give you my speech in about 10 seconds, I think, first you have to reduce the budget deficit. You have to give some serious thought to Third World debt and how to stretch it out and give LDC's some chance to grow. I would put tax reform in there too, personally.

But fourth, I would add a willingness to intervene at selected times in the exchange rate markets. And if you put the question to me how would I rather spend $3 billion, the best to improve the economic circumstances of the country, I would pick $3 billion intervention because I think that the upside potential on the exchange rate is significant and important enough to the economy that by the sale of that $3 billion we could improve the economy more than we could improve the economy through $3 billion of deficit reduction. It doesn't mean that I don't think budget deficit reduction is important, but it means that on the relative merits I would choose I intervention.

The currency markets function on a minute-by-minute basis. As I talk to traders out there, I hear them say: we don't know what day an intervention within a fiscal quarter is going to be. Indeed the Fed has the flexibility in any bill to decide what day, and so you wouldn't have everybody coming up to the 15th of October and hedging up to the 15th of October and then cutting after the 15th.

Under my bill, intervention might have to occur someday in a quarter but it won't be any particular day. And I would argue that if it occurs, you would get arbitraged on the other side of the issue, so that it wouldn't be a speculator's paradise; particularly compared to the current situation, which in my view has been a speculator's paradise.

Mr. LEACH. I appreciate your views. I was only hoping with my endorsement that you would make an announcement.

Senator BRADLEY. I think this room is extremely attractive, but if that were going to happen, maybe I should make it in this room.

Thank you very much, Mr. Chairman. I really have to go.

Chairman NEAL. Thank you so much for coming. You have been most generous with your time.

Senator BRADLEY. And I appreciate your openness and generosity to at least having this discussion take place here. I think it is important. I would hope that there would be ways in this process in which we could improve this initiative to the point where it would be acceptable. I stand ready and willing to talk at any point with you or any Member of the committee about it, and I undoubtedly in those conversations would learn as much as I would convey.

Chairman NEAL. Thank you very much. We are all concerned about the problem. Obviously, there is a little bit of a difference of opinion about how we can most effectively deal with it. Thank you very much again for coming over.

Stan, did you want to say something?

Mr. LUNDINE. I would just like to respond to one thing that my friend and colleague Jim Leach from Iowa said. He said we thought it was the Fed's fault, the situation we are in. I don't believe that myself. The point is that we haven't given the Federal Reserve any direction. It is our fault. It is the Congress' fault, not only because of how we have conducted fiscal policy, but in terms of unemployment and inflation, we have given the Fed some general guidelines. We haven't done that with regard to exchange rates, and I think it is not unreasonable that we give some general direction that a stable, reasonable level of exchange rate is also an important national policy objective.

When we do that, and then the Fed disregards it, it would be their fault, but now we have been silent on the point, and I don't think we should be silent any longer.

Chairman NEAL. Mr. McCollum.

Mr. McCOLLUM. I just would like to make one comment relative to this, and kind of ask a question, Stan, and of Professor Poole. I question how much of the marketplace in the exchange rates is speculative as opposed to fundamental investment in U.S. dollars.

I am the ranking minority member on the Domestic Monetary Subcommittee, and we had hearings on this last week, in which a number of the witnesses indicated to us that the intervention which has already taken place, and the other processes that have gone on in the marketplace of the dollar where it has come down some, have basically burst that portion of the dollar's value that was speculative, and while there may be a very tiny marginal amount of additional speculative point there, that we really have already seen it.

They also argued to us, a number of them, that there is a lag time of 18 months or maybe up to 2 years between the value of the dollar coming down before you can see the fundamental trading changes that we would expect to see from this decline, and I think there are substantial voices out there who would say that while we don't want to see the dollar go back up any more, and surely we would like to see it come down some more, maybe very gradually, that what we want most of all is to see it stay about where it is now, and let's see the effects of what has already happened, and that the speculation is largely already out of the marketplace.

What do you feel about that, Stan?

Mr. LUNDINE. First of all, I think that there is a considerable speculative market. Granted it does not in any way equal all of the transactions and all of the investment that is involved in interna-

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tional capital movements, but it is nonetheless considerable again at the margins from what I have been able to learn.

Second—I am sorry, I can't remember the second part of your question.

Mr. McCollum. Well, the idea was not only the speculative question but the fact that we need time.

Mr. Lundine. Professor Poole can explain much better than I, I am sure, but there is what the economists call a j-curve effect. In other words, initially when the value of the currency, in this case the dollar, goes down, you will actually have a perverse effect for a short time that will actually tend to increase imports and decrease exports. That is a very short period of time, and we are going to have to face it. If we believe that the dollar is overvalued, we are going to have to face it, I would say sooner better than later.

I do not accept from all that I have been able to learn that there would be a 2-year or even an 18-month lag period between the time the currency comes down and the time you would begin to regain competitive edge. I think there is a 2-year, generally thought to be a two-year relationship between money growth and the impact that it might have on inflationary trends.

Mr. McCollum. Could the professor comment on the whole idea of whether the speculative bubble has already been taken out, how much of this is speculative, and whether we have done enough already on bringing the dollar down for now?

Mr. Poole. Let me get to that by reading the last paragraph of my statement, which I think is exactly that point. I will read it the way I wrote it, since I tried to write it carefully:

The bottom line is that a strong U.S. economy makes our Nation attractive to foreigners as well as to our own citizens. Foreign investors want to move their capital here. People want to cross our borders, legally or illegally. Success creates problems. We know how to cure those problems; many unfortunate nations around the world have provided lessons on what policies to follow to encourage people and capital to move away. My fear is that in our concern over the dollar problem we will follow some of those same policies, especially acceleration of inflation.

Now, if we have a very attractive business climate here, we will attract people and capital, and they will be attracted for fundamental reasons and not because of speculative reasons. Speculators, in my view, on the whole make markets work better rather than worse, and the evidence on this is not that speculators disrupt markets but they make markets work more smoothly because they absorb short-run fluctuations that would otherwise be disruptive. But we don't need to get into that. The basic point is that the conditions in the United States are much more attractive than they were in 1980, especially relative to the conditions abroad.

If you think back to the late seventies, say 1978–79, we had rising inflation. We had a lot of uncertainty about the regulatory environment. Lots of things were going on here that were very unattractive for business investment, and so people took funds abroad, to Latin America, to Europe, to Southeast Asia—just the natural thing for people to do. They also put money in gold, antiques, and stamp collections, almost anything except business capital. I am exaggerating, of course.

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At the same time, Latin America and Europe looked like pretty good places to invest. Now, what has happened? What do we look like right now? The European economies are stagnant. They are growing slowly. They have very serious structural problems. The Latin American economies are struggling to regain some equilibrium. Nobody wants to send capital to those places anymore. The United States is the place in the world to invest. That is what has driven up the value of the dollar, because of the success of turning the thing around.

Now we have got a lot of things to do yet, and there are a lot of problems we have to face.

Let me make a comment about the budget deficit. I think the budget deficit is very important, but if we can improve our fiscal situation, stabilize it, while at the same time not upsetting these economic fundamentals—low inflation, a favorable business investment climate—my prediction is that we will make the dollar stronger rather than weaker, and that is contrary to the predictions of many others. But the way I like to put it is this: find me a case in history of a country that has had severe fiscal problems and has been able to put its house in order, and has found itself with depreciating currency. It doesn't work that way. Countries that put their fiscal house in order become more attractive.

One of the problems that we have right now that might be tending to hold the dollar down is great concern about where our tax laws are going to go. It has taken the growth out of business investment. Business investment is now stagnant in the United States, resulting from the widepread uncertainties that investors have about what the Congress is going to do and what the President will eventually sign. Who wants to invest under these circumstances where you don't know where the tax laws are going to lead, what the returns are going to be?

Let me make a quick comment about the G-5 intervention. The G-5 intervention is not, in my view, a good example of intervention that moves the exchange rate in the absence of fundamental policy changes. That was exactly my point when I said I think that the G-5 intervention is locking us into a much increased risk of an inflationary policy in the United States.

If we had had a change in monetary policy for any other reason—problems in the housing industry or whatever—that had exactly the same promise for inflationary policy in the United States, the monetary policy change would have had the same kind of effect on the foreign exchange market.

Why is the move against the yen so great? It is because the Japanese have moved to a clearly tighter monetary policy. They have raised their interest rates. They are slowing their money growth, and so there has been a change in the policy fundamentals flowing from the G-5 intervention. That was my main point—to say that this intervention should be best viewed as involving a change in policy fundamentals in the United States, and to some extent abroad.

Mr. LUNDINE. Could I make one comment at this point, or do you want to ask a question?

Mr. **Parris**. Let me just follow that up. I will be extremely brief. I am trying not to talk at all, which you will be delighted to hear, but I just want to follow that up very quickly.

I just finished a very quick review—I won't dignify it with the word study—on the financial return on international investment in foreign currency deposits. And the numbers, it seems there are something like, on Swiss francs, 23 percent; 6½ percent of that is the interest rates you can get at the Barton's Bank in London and 16 percent is the depreciation because of the fall of the dollar versus the franc. I am also told that the recent history is that there is an increasing amount of dollars being exported for these purposes by American speculators, traders if you will.

My question is assuming that is all correct—and I believe it to be—is in fact the situation changing, as Mr. McCollum suggested, and the exchange rate improving by virtue of some forces already at work in terms of the dollar exchange rate, so that that will in fact continue to exist, or are we going to see the usual inflow of speculator dollars in dollar-based investments?

Mr. **Poole**. I fear, as I said, that the situation is changing, because I am very concerned about the policy fundamentals in the United States. We don't want to shoot ourselves in the foot or worse—I think we are shooting ourselves in the stomach, with what we are doing here.

Mr. **Parris**. Or the base of the brain.

Mr. **Poole**. Or whatever. What we ought to want is for the dollar to weaken not because we screw up the economic situation here, but because the countries abroad put their houses in good order.

It is interesting that the depreciation of the dollar has not been all that great against the Japanese yen, because the Japanese economy is fundamentally pretty strong, and if you look at what has happened over the last 5 years, the dollar has not appreciated all that much against the yen, certainly far less than against the European currencies and, of course, the Latin American currencies. So, the currencies that have depreciated the most against the dollar are the currencies for those countries that have serious economic problems. What we ought to want is for those countries to get themselves going—these are countries that have unemployment rates of 9 to 13, 14 and 15 percent. They are really in serious trouble. If you think we have fiscal policy problems, you should look at the problems in Europe.

Mr. **Lundine**. Mr. Chairman, I would really like to respond to the final question Mr. McCollum raised and a few points by Mr. Poole because I think this is really at the heart of it. If we were such an attractive investment climate, then how come we have the highest real interest rates in the last 50 years? I mean, that is the premium we are having to pay to draw money into this country. I think we are deluding ourselves if we think it is cheap, having to keep our interest rates so much higher than our inflation rate.

The fact is it hasn't been big capital inflows that have caused this imbalance. It has been a halt of our own bank lending primarily to lesser developed countries. It has been a decrease in the capital outflows, not a substantial increase in the capital inflows that have caused this imbalance to occur.

Obviously, we all want the fundamental climate for investment in America to be good. We want that in Florida, in northern Virginia, in North Carolina and upstate New York and throughout this country. We welcome Japanese investment. They are running a huge trade surplus, and we hope they will invest it, hopefully not have to invest it in T-bills but in factories. That is a good thing in Tennessee or upstate New York or wherever.

The question, though, that I think Bill McCollum correctly posed is, has the dollar come down enough? And the answer I say is clearly "No." I mean, it was overvalued by 30 to 40 percent against the average basket of other currencies. It is true it is not quite as different with the yen as others. Some currencies are weaker and others are stronger, and the reasons for that are fairly obvious, but still our dollar is overvalued in comparison to the yen, by 10 to 20 percent.

It is still overvalued in regard to the average of European currencies by 20 to 30 percent, so we don't want it to plummet, and the Bradley-Lundine approach gives us a strategic capital reserve, if it did ever get on a slippery slope, and it gives us a way of dealing with that situation. But we do want it to continue to ease down while trying to maintain ourselves, in fact improve ourselves for our fundamental investment climate.

Mr. POOLE. I would like to make a short point about the real interest rate. The real interest rate is a type of price, and so let's go back to the very first lesson in economics. If you see a price go up, you have to ask whether the price has gone up because of an outward shift in a demand function or an upward and leftward shift in a supply function. There are two ways that price can go up.

How do you tell the difference? You look at what has happened to quantity. If you see a price go up and you also see quantity increase, then you can guess that probably it is because the demand function has moved out, and if you see price go up and quantity fall, it is probably because a supply function has moved up and to the left.

In the case of the real rate of interest, the answer is that the quantity, business investment in the United States—that is what is controlled by the real rate of interest, indeed all investment, housing also—that investment has done very, very well. The table I have in my statement in some respects understates how well investment has done, because I constructed this table using ratios of current dollar values instead of constant dollar values in the GNP accounts, a rather technical issue that I don't need to get into, but the basic point is investment has done very, very well.

Now look at the logic of this. Suppose you have a situation where, for whatever reasons, there is a big increase in the rate of return on new business investment—changes in technology, changes in the tax law, whatever it is. Suppose business investment suddenly becomes very profitable. Well, then what investors do is to turn away from financial instruments, Government bonds, and they sink their capital into plant and equipment because the return is so good, by assumption.

What does that do to the rate of return in the financial markets? Well, it drags that return up too. The rate of return in the financial markets has to be competitive with the rate of return on plant and equipment. So, what I think has happened is that we have a major improvement in the rate of return on new business investment—again, it is on an anticipated basis and it has to be on an after-tax basis—in the U.S. economy, because of a variety of things that have happened.

I would point to the 1981 tax law, which we all know involved accelerated depreciation. That has cut corporate taxes a lot. We have lower inflation, which is very good for business investment. We have an improved regulatory climate. Regulation caused a lot of problems in the seventies, because you can destroy the return on capital by having regulations that make it so expensive to operate your capital. A whole variety of other conditions have improved. We have an improved labor situation. There are fewer strikes. Markets are generally more orderly. All of those things have increased the rate of return on investment.

Now, you point to the 1920's. Let's remember that the 1920's were a decade of wonderful prosperity. This was a decade of growth, of full employment on the whole. There were some short recessions. It ended in a disaster in the early thirties, but that disaster was not due to a high real rate of interest. That high real rate of interest was a symptom of the high rate of return on new investment.

The same thing was true in the 19th century in the United States, when this was a vigorously developing country. Immigrants poured in here, and capital poured in here. We had trade deficits at that time that are comparable to the ones that we have now, and that was a result of the capital that poured in from Europe to build our railways and many of our other facilities. The returns were high. That is why the capital came.

Chairman **Neal**. Let me ask a technical question about the bill. As I understand it, there is a requirement that the Fed would print up $12 billion for purposes of intervention, in addition to whatever else it does for monetary policy purposes. Is that correct, Stan?

Mr. **Lundine**. Basically, yes, on an annual basis.

Chairman **Neal**. If they had done that over the last year, that would have meant that bank reserves would have grown at the rate of about 24 percent instead of 12 percent. Those aren't exact figures, but that just sounds awfully inflationary to me.

Mr. **Lundine**. No, no; they can do that by simply participating in foreign exchange rates rather than domestic. There is nothing that says that it has to be in addition to the dollar.

Chairman **Neal**. That is in effect sterilizing reserves?

Mr. **Lundine**. They can offset it, that is right.

Chairman **Neal**. You mean——

Mr. **Poole**. The calculations, Mr. Chairman, are roughly this. In fact, I think my statement underestimated the problem, because I was just fiddling with a few numbers here. The monetary base is in the neighborhood of $230 billion right now, so if you add $12 billion to that, that is approximately 5 percent. I don't have a calculator with me, but roughly speaking 5 percent. A 5 percent increase in the monetary base will increase the money stock by about 5 percent.

Since this takes place over the course of a year, we are talking about 5 percentage points of extra money growth in the course of a year, given the numbers the way they are right today. Five percentage points on top of what we already have is a very significant increase. Of course if you were up at the upper end above the $3 billion per quarter you would be talking about a really huge number. If you were talking about it being offset—the Federal Reserve has the flexibility to offset it—but then that is what sterilized intervention is.

Mr. **Parris**. Which was ineffective last winter?

Mr. **Poole**. Which is ineffective.

Chairman **Neal**. If there are no further questions or comments, we will adjourn the hearing. We have a hearing scheduled for next Tuesday at 10 a.m.

Stan, thank you so much. Professor, thank you, sir, very much for coming. It has been most useful.

[Whereupon, at 12:40 p.m., the subcommittee adjourned.]

THE STRATEGIC CAPITAL RESERVE ACT OF 1985

TUESDAY, NOVEMBER 19, 1985

House of Representatives,
Subcommittee on International Finance,
Trade and Monetary Policy,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 10:08 a.m., in room 2220, Rayburn House Office Building, Hon. Stephen L. Neal (chairman of the subcommittee) presiding.

Present: Chairman Neal; Representatives LaFalce, Levin, and Grotberg.

Also present: Representative Stan Lundine of the full committee.

Chairman Neal. I want to call the subcommittee to order at this time.

At our first hearing I stated my opposition to H.R. 3498. I would like to summarize now briefly my reasons.

This bill calls for large amounts of foreign exchange intervention. Leaving aside, for a moment, the wisdom of such intervention, I would like to point out several puzzling features of this bill. It sets up a new fund—a "Strategic Capital Reserve"—when a perfectly good one—the Treasury's Exchange Stabilization Fund, ESF—already exists. The ESF was established long ago, for the same general purpose as the proposed Strategic Capital Reserve. It has over $12 billion in total assets, of which over $4 billion are dollar assets. I don't understand why it is ignored, in favor of some entirely new Strategic Capital Reserve.

At least the Exchange Stabilization Fund has real funds, whereas the Strategic Capital Reserve would appear to be empty. This bill authorizes no appropriation of funds to this Reserve, and provides no authority for the Treasury to borrow. I suspect this is not just a technical oversight, but an effort to avoid calling attention to the budgetary consequences of funding this Reserve.

Filling the Strategic Capital Reserve with funds would, of course, sharply increase the budget deficit. The Treasury would have to borrow the money, and the budget deficit would rise accordingly. At our last hearing, the proponents of this bill indicated that, over the past year, it would have triggered a minimum of $12 billion in intervention.

Let me call the subcommittee to order once again.

Since the Treasury would have had to borrow every penny of these funds, our deficit would have been at least $12 billion larger than it was. Thus H.R. 3498 is at least a $12 billion budget buster.

Even if we resorted to budgetary tricks, such as putting it "off-budget," no one would be fooled, least of all the financial markets. Treasury borrowing for this Reserve would have the same impact on the economy as Treasury borrwing for any other purpose. This seems a rather peculiar solution to a problem—dollar overvaluation—which is widely thought to be caused by excessive Government borrowing.

The major purpose of this bill is, I think, to mandate unsterilized intervention. That was the claim made by its proponents at our first hearing. This seems to be the import of section 5. But, as currently written, section 5 actually prohibits unsterilized intervention. Look closely at its language. It directs the Fed to disregard intervention mandated by this bill in its conduct of monetary policy. That intervention would come out of the Treasury's new Strategic Capital Reserve. But the Treasury cannot create money.

It can raise money only by taxing or borrowing. Intervention with borrowed funds is sterilized intervention. Section 5 would then require the Fed to disregard that intervention in its conduct of monetary policy. Intervention that has no impact on monetary policy is, by definition, sterilized. Thus, I conclude that H.R. 3498 actually prohibits unsterilized intervention.

These points stem from technical flaws in the bill. I raise them only to emphasize that intervention is not a free lunch. We have to pay for it, by raising taxes, by increasing the budget deficit, or by printing money. The intent of this bill, I think, is to pay for it by printing money. For that purpose, the establishment of some new fund is simply irrelevant. In fact, the Treasury itself is irrelevant, since only the Federal Reserve can create new money.

If the bill were rewritten to require truly unsterilized intervention by the Fed in the amounts specified in section 3, what could be the consequences?

Unsterilized intervention increases bank reserves, and hence the "monetary base," by the amount of the intervention. Between October 1984 and October 1985, the monetary base grew by about $16 billion, at a rate of about 7.4 percent. That growth in the base produced a growth in the money supply, M1, of about 12 percent. I think monetary growth at 12 percent is dangerously high, if sustained for very long. I fear it threatens to rekindle inflation, unless soon restrained.

I now ask what impact this bill could have had on that already highly expansive monetary policy. It was suggested at our first hearing that under this bill the Fed would retain its independence and flexibility in the conduct of monetary policy. That is simply not true. This bill would mandate major shifts in monetary policy in accordance with a rigid, mechanical rule. The Fed's independent, freely chosen policy over the last year yielded a $16 billion expansion in the monetary base.

This bill, its supporters claim, would have required the Fed to create at least another $12 billion through unsterilized intervention. The base would have grown by $28 billion, not $16 billion. By extrapolation, the money supply would have grown at something like 21 percent, an explosive rate without precedent. The bill would have effectively revoked Federal Reserve control over monetary policy, and produced a monetary explosion far beyond what the Fed wanted.

These numbers suggest the general magnitude of the inflationary danger we would court by forcing a shift in monetary policy on such a scale. Whatever the impact might be on real exchange rates, a return to double digit inflation would be too high a price to pay. That danger is my primary reason for opposing H.R. 3498.

My secondary reason stems from the impact this bill could have on the domestic economy. If it actually worked to restore the current account balance, we would then no longer receive capital inflows from abroad.

Our entire demand for credit, arising from private investment and from Government borrowing, would have to be met by our domestic savings. But our savings are woefully inadequate to meet that demand.

When the demand for credit exceeds the supply, interest rates must rise. Since I doubt Government borrowing will be much reduced, equilibrium in the credit markets will be restored by rising interest rates stifling private investment. Recent testimony before another subcommittee estimated the necessary rise at about 300 basis points, in real terms. Obviously, sectors like housing could be seriously hurt. Developing country debtors would be severely hit.

In short, it is quite possible that this kind of legislation would squash our interest-sensitive domestic sectors, include LDC debt default, and reignite inflation. That is too big a risk to run.

I hope our subcommittee will not endorse this bill.

At this time, I would like to ask if there are others on the subcommittee who have opening statements before I call on the witnesses.

Mr. LaFalce.

Mr. LAFALCE. Thank you, Mr. Chairman.

I find myself in a somewhat difficult intellectual position because I certainly favor and favor strongly the concepts that motivated these bills. I support having some strategic currency reserve to greater facilitate appropriate intervention, and also have long advocated an international monetary conference going parallel with the GATT talks to deal with the misalignment of our exchange rates.

The two bills that we have before us deal with the uncompetitive overvalued dollar and our disastrous trade deficit.

It is my belief that the administration has long ignored these problems. I think it is a tribute to Mr. Mulford and Secretary Baker that recently they have not ignored it and have attempted to shed the theological approach that was taken the first 4 years through a much more pragmatic approach.

What I am concerned about, however, is with the specifics of the bill so also I am most concerned we are rushing to judgment and we have a markup scheduled for Thursday and the first hearing was last week, and the second one today, and it is such a complex subject.

I for one think it is highly inappropriate to have a markup session this Thursday. I wouldn't want to defeat the bill, but I wouldn't want to pass them as is either. I personally think we simply need more time to study the issue and come up with a better legislative vehicle to accomplish our goals.

H.R. 3498 is highly mechanistic. It has a rigid manipulation based on a formula and I am fearful whenever you have a formula in legislation, it could have adverse consequences. Certainly one of the adverse consequences of this formula might well be rekindling of inflation.

We clearly do need greater coordination of macro economic policy at the international level. We clearly must work with our trading partners to reform the international monetary system.

I am not sure that the second bill is fully adequate to the task.

The Secretary of the Treasury is the administration's top policymaker for domestic and international economic issues. He also makes the decisions on U.S. intervention in exchange markets. At least until the United States stops running up large foreign debts, the Treasury Secretary should appear before Congress to present his strategy for bringing the dollar to a level that assures trade competitiveness for American industry and agriculture.

He should have to set goals for the dollars' value to make U.S. producers competitive and propose measures to bring the dollar to those levels, or justify why they cannot be achieved. Such proposals should include changes in domestic policy including Government revenues, spending, and monetary policy, designed to reduce our current dependence on foreign borrowing.

The Secretary should also be required to report on his efforts internationally to obtain cooperation in and reforming of the international exchange rate system. The administration wants to begin new international negotiations on trade as soon as possible in GATT or elsewhere as necessary. Since the exchange rate represents our largest single trade program, we must realize international negotiations to resolve our trade problems have to address the exchange rate issue as well.

There are no simple solutions but the GATT issues have no simple solutions, either.

In my view any proposal we advance should, one, increase the accountability of the President for the impact of exchange rates on trade competitiveness by stringent reporting requirements. Two, it should require the President to develop proposals for changes in domestic and international economic policy that would bring the dollar to a more competitive level. Three, it should require the convening of an international conference on monetary reform. And four, should require the President to adopt strategies for U.S. Government intervention in currency markets in concert with other nations to adjust the value of the dollar toward competitive levels and create a strategic currency reserve for part of the use in such a successful strategy.

I would hope, Mr. Chairman, we would have some time to help accomplish those goals but do it with appropriate legislative vehicles. I think that will take more time than the 2 days remaining between now and Thursday.

[The opening statement of Mr. LaFalce follows:]

OPENING STATEMENT OF CONGRESSMAN JOHN J. LaFALCE (D-N.Y.)

Hearing on H.R. 3498 and H.R. 3573
November 19, 1985

Mr. Chairman. The two bills that we will continue to discuss today attempt to deal with one of the primary factors behind our disastrous trade deficit -- the overvalued and uncompetitive dollar. It is a problem this Administration has only recently acknowledged. For years the Administration has praised the high dollar as emblematic of our economic leadership. But the inflated dollar has imposed undue competitive pressure and great distress across a broad spectrum of American industry and agriculture. Continuing inequity in currency values will only exacerbate these problems. I am grateful to you, Mr. Chairman, and to Mr. Lundine for the leadership you have both provided to the Subcommittee on this issue.

I am concerned, however, that we not adopt illusory "quick fix" solutions to a very complex problem. In that regard, I have serious doubts about H.R. 3498. This bill would create a "Strategic Capital Reserve," the use of which would be governed by a rigid, mechanistic formula. First of all, such a reserve provides no ready solution to our exchange rate problem. Maintenance of a reserve is, in fact, intended to reduce the value of held currencies -- clearly not the problem we face. It is the pattern of intervention not the reserve which must be "strategic." Secondly, rigid manipulation of such a mechanism could rekindle inflation. Finally, intervention itself is no panacea. The daily market for dollars in exchange markets has grown so large that the U.S. Treasury alone can no longer amass the resources to alter the value of the dollar substantially and permanently. The creation of a "Strategic Currency Reserve", standing alone, cannot resolve our exchange rate problems. If more targeted intervention is to be effective, it must be part of a larger strategy.

A real solution to our exchange rate problems must involve many elements. We need a serious commitment to deal with our enormous federal deficit and correct the imbalance in our own fiscal and monetary policy. At the same time, we must seek greater coordination of macroeconomic policy at the international level and work with our trading partners to reform the international monetary system to correct exchange rate misalignments. As we have observed since the G-5 meeting in September, decisive, direct interventions could be a useful part of such a broader strategy.

Given these concerns, I fear H.R. 3573, the other bill under consideration, does not go far enough. A key element in any proposal we advance should be increasing the accountability of the President for the impact of exchange rates on trade competitiveness and the policy initiatives necessary to correct the exchange rate problems we face.

The Secretary of the Treasury is the Administration's top policy-maker for domestic and international economic issues. He also makes the decisions on U.S. intervention in exchange markets. At least until the United States stops running up large foreign debts, the Treasury Secretary should appear before Congress to present his strategy for bringing the dollar to a level that assures trade competitiveness for American industry and agriculture. He should have to set goals for the dollar's value to make U.S. producers competitive and propose measures to bring the dollar to those levels -- or justify why they cannot be achieved. Such proposals should include changes in domestic policy -- including government revenues, spending and monetary policy -- designed to reduce our current dependence on foreign borrowing. The Secretary should also be required to report on his efforts internationally to obtain cooperation in lowering the dollar and reforming the international exchange rate system.

The Administration wants to begin new international negotiations on trade as soon as possible -- in the GATT or elsewhere if necessary. Since the exchange rate presents our largest single trade problem today, we must recognize that international negotiations to resolve our trade problems have to address the exchange rate issue as well. There are no simple solutions, but the GATT issues have no simple solutions either.

In my view, then, any proposal we advance should: (1) increase the accountability of the President for the impact of exchange rates on trade competitiveness by stringent reporting requirements; (2) require the President to develop proposals for changes in domestic and international economic policy that would bring the dollar to more competitive levels; (3) require the convening of an international conference on monetary reform; and (4) require the President to adopt strategies for U.S. government intervention in currency markets in concert with other nations to adjust the value of the dollar toward competitive levels and create a "Strategic Currency Reserve" for potential use as part of such a strategy.

Chairman **Neal**. Thank you.

Mr. Lundine. Do you have an opening statement?

Mr. **Lundine**. No. I will put you down as doubtful and—Mr. LaFalce as leaning in favor.

Mr. **LaFalce**. The definition of an optimist.

Chairman **Neal**. Well, this morning we are honored to have two distinguished witnesses to begin today's hearing, Hon. Donald Pease, our colleague from Ohio, and Mr. David Mulford, Assistant Secretary of the Treasury for International Affairs.

We would like to hear from both of our witnesses and then have a little opportunity for questions and, Don, let's start with you. We would in the interest of time like to put the entire statements in the record, and we will do that without objection and urge you to all summarize to the extent that you can and still make your points.

STATEMENT OF HON. DONALD J. PEASE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. **Pease**. Thank you very much, Mr. Chairman. I am pleased to be here this morning and I am here because over the last couple of months in the process of putting together a major trade bill, it became crystal clear to me that currency valuations are an indisputable part of our trade problems and I attempted to address those fluctuations to a degree in the bill that I introduced, but I recognize that this subcommittee has far more jurisdiction and far more influence over those matters than does the Ways and Means Subcommittee on Trade, on which I serve.

The focus of the work of this subcommittee with reform of exchange rate policy and the international monetary system as I say has a much more direct and profound influence on the magnitude of the trade deficit. My purpose, therefore, is to remind members of the committee, if you need it which I doubt, of the central importance of trade in any analysis of and prescription for international monetary problems.

The basic goal of postwar international monetary arrangements has been to provide for a system in which exchange rates reasonably reflect the relative prices of tradable goods in different countries; fixed rates were abandoned when they failed to measure up to this test in the early 1970's.

Flexible rates have not fared much better, especially in recent years.

We no longer live in a textbook world, in which the purchase and sale of foreign currency is primarily a function of business decisions to finance trade or to establish productive facilities in another country.

Today supply and demand conditions and currency markets are primarily determined by transactions in financial assets such as CD's, Government bonds or commercial bank loans.

It is economically inefficient and in my view inhumanely unfair for the lives and jobs of people in tradable goods sectors of our economy to be subjected to large movements in exchange rates, and the same type of volatility as that found in financial markets.

To have a laissez-faire exchange rate policy in the current flexible rate environment of high capital mobility is to tragically and irresponsibly equate jobs, people and communities with stocks and bonds.

Mr. Chairman, the challenge we face is how to reconcile our desire to pursue domestic economic objectives that we might wish to pursue with the need to keep exchange rates from distorting the competitive position of our tradable goods sector.

Stan Lundine's bills are a long overdue recognition of the need for the present and future administrations to make hard, conscious decisions when these two requirements conflict. In my view, this administration took too long to face up to its responsibility in this regard. Its delay cost countless American sales and jobs and sparked protectionist sentiment unparalleled in postwar history.

Indeed, the administration still has a long way to go.

But I would acknowledge as you have earlier today, that the administration is moving and that under the current Secretary of Treasury there has been commendable progress. While there is no substitute for presidential leadership, Congress clearly should do what it can to prevent a misalignment of the dollar from occurring or recurring. Intervention in the foreign exchange markets is one of the tools at our disposal in view of what I have already said. There is a reasonable consensus that intervention can be effective in preventing or reducing the overshooting of rates.

Whether or not this intervention is likely to compromise domestic economic objectives depends on what is meant by overshooting. In my view, it would make sense as a matter of policy to use foreign exchange intervention if the exchange rate has moved out of step with key economic indicators and away from what Dr. Bergsten's colleague, John Williamson, calls its current equilibrium. However, it does not necessarily make sense as a matter of policy to prescribe foreign exchange intervention to cover the final distance between the rate justified by those economic indicators and the rate reflected in a true measure of the international competitiveness of American goods, known as fundamental equilibrium.

This distance is better covered by adjustments in Government policy here and abroad, to change the indicators to which the markets react. Using foreign exchange intervention in this case would be tantamount to making monetary policy either here or abroad a slave of exchange rate policy, with undesirable inflationary or deflationary consequences.

There is strong evidence that this is happening today. Three weeks ago ten year Japanese bonds were yielding 5.56 percent, late last week they were trading at over 7 percent. Short-term yen deposit rates have risen to over 8 percent, while inflation remains a paltry 1 percent.

Japanese monetary authorities are obviously compensating for rather than coordinating with American exchange rate policy or lack thereof, with ominous implications for world trade and economic growth.

The GTT secretariate forecast growth in world trade this year to fall to between 2 and 3 percent, from a rate of 9 percent in 1984. The last thing the world economy needs now is for Japan to deflate with real interest rates of 6 or 7 percent.

Now the question is, how can Congress limit overshooting by insuring that foreign exchange intervention and policy coordination are carried out by the administration at the appropriate times?

H.R. 3498 and H.R. 3573 are worthy attempts to answer this challenge. Foreign exchange intervention called for by H.R. 3498 is generally a useful, short run tool which should be used in certain cases of overshooting. However, it is difficult for Congress to formulate precise rules and prescriptions which take into account the subtle distinctions and subjective judgments involved in the day-to-day management of financial and currency markets.

I believe this is the point Mr. LaFalce was making a few minutes ago.

This job in my view is better left to the executive branch. Nonetheless, Congress can provide for the process which will ensure that problems are explicitly recognized and corresponding policy decisions are made. That is what the suggestions I have made in my written testimony are designed to accomplish.

In short, they are an attempt to institutionalize procedures to identify and deal with cases of currency overshooting in which foreign exchange intervention is warranted.

For the time being, it would be unwise to use foreign exchange intervention other than to insure that the gains of the G-5 initiative are not reversed. We do not want to undesirably compromise the Federal's goal of pursuing noninflationary monetary policy.

I appreciate the chairman's concerns in that regard. Presumably the G-5 authorities are already committed to intervene to prevent a reappreciation of the dollar. Our focus should now be on what everybody knows is the bottom line when it comes to preventing or in a current context correcting an exchange rate misalignment, international policy coordination.

I am sure this is what the sponsors of H.R. 3573 have in mind. They justifiably believe that the likely outcome of an international monetary conference would be an agreement, formal or informal, among the key trading nations aimed at keeping exchange rates more in line with the underlying competitive relationship of their tradable goods sectors.

They presumably hope that such an agreement would be the catalyst for the enhanced coordination of national economic policies on which successful international monetary reform depends. I agree, and I support their efforts. However, they accurately characterize this as a long-term strategy. Mandated unsterilized foreign exchange intervention is to be the short-term strategy.

As I have mentioned, however, this short-term strategy has already been implemented, albeit, belatedly in the G-5 accord. This leaves us with only a long-term strategy to deal with a still serious immediate problem. Accordingly, I would urge the subcommittee to consider taking more direct and short-term action to deal with the international macroeconomic coordination issue.

Here again I suggest in my written testimony that Congress establish guidelines that will ensure that the question of international policy coordination is squarely addressed by the administration in an ongoing basis. Why wait for an international monetary conference to start this process?

Congress, itself, can get the ball rolling by requiring the administration to use the machinery for international monetary consultations already at its disposal. But as the old saying goes, you can lead a horse to water, et cetera, et cetera, et cetera.

Procedures are no substitute for decisions and actions. In my view the source of the current U.S. budget stalemate is the President's refusal to work with congressional moderates of both parties to formulate a package of balanced spending reductions and revenue increased. Today the price of the administration's obstinacy is American jobs in sectors of the economy. Before long, however, that price will escalate and perhaps irreversibly erode the economic and political vitality of this country.

It is for this reason, as I mentioned at the outset, that title I of the omnibus bill of alternative trade legislation introduced the other week, would force the President to choose between following through on G-5 within 1 year and imposing import restrictions.

It is time, Mr. Chairman, that the administration fully faces up to the consequences of its continued recalcitrance. I thank the committee for its indulgence.

[The prepared statement of Mr. Pease follows:]

STATEMENT OF CONGRESSMAN DON J. PEASE

SUBCOMMITTEE ON INTERNATIONAL FINANCE, TRADE, AND MONETARY POLICY

NOVEMBER 19, 1985

I am particularly pleased to have an opportunity to testify before this subcommittee this morning. The Ways and Means Subcommittee on Trade, of which I am a member, is likely to hold hearings and mark up comprehensive international trade legislation early next year. Most of our work will be concerned with trade policy or, roughly speaking, how to cope with the trade deficit rather than how to reduce it and make certain it doesn't balloon out of control again.

The focus of the work of this subcommittee --- reform of exchange rate policy and the international monetary system --- has a much more direct and profound influence on the magnitude of the trade deficit. Perhaps it is my symbolic duty, therefore, to remind members of this committee of the central importance of trade in any analysis of and prescription for international monetary problems.

The basic goal of postwar international monetary arrangements has been to provide for a system in which exchange rates reasonably reflect the relative prices of tradeable goods in different countries. Fixed rates were abandoned when they failed to measure up to this test in the early 1970s. Flexible rates have fared even worse, particularly in recent years.

The Reagan Administration overlooked this principle until recently. Inevitable protectionist pressures have now forced it to join most of the rest of us in recognizing that the markets cannot always be relied upon to produce exchange rates conducive to efficient trade and investment decisions and steady growth in world trade.

The reason for this, of course, is that exchange rates now dance to the tune of international portfolio capital movements rather than changing patterns of trade in goods and services and investment in productive capital. In other words, we no longer live in a textbook world in which the purchase and sale of foreign currencies is primarily a function of business decisions to finance trade or to establish productive facilities in another country. Today, supply and demand conditions in the currency markets are primarily determined by transactions in financial assets such as certificates of deposit, government bonds, or commercial bank loans.

It is economically inefficient and inhumanely unfair for the lives and jobs of people in tradeable goods sectors of the economy to be subjected through large movements in exchange rates to the same type of volatility as that found in financial markets. To have a laissez-faire exchange rate policy in the current flexible rate environment of high capital mobility is to tragically and irresponsibly equate jobs, people and communities with stocks and bonds.

It apparently took protectionist pressures not seen since the Great Depression to make believers out of the Administration. However, some people, as demonstrated by Professor Poole's testimony last week, have yet to make this important distinction.

Mr. Chairman, the challenge we face is how to reconcile our desire to pursue domestic economic objectives as we choose with the need to keep exchange rates from distorting the competitive position of our tradeable goods sector. Stan Lundine's bills are a long overdue recognition of the need for the current and future Administrations to make hard, conscious decisions whenever these two requirements conflict.

This Administration took too long to face up to its responsibility in this regard. Its delay cost countless American sales and jobs and sparked protectionist sentiment unparalleled in postwar history. Indeed, the Adminstration still has a long way to go. But while there is no substitute for presidential leadership, Congress clearly should do what it can to prevent a misalignment of the dollar from recurring.

Foreign Exchange Intervention

Intervention in the foreign exchange (FX) markets is one of the tools at our disposal. There is a reasonable consensus that intervention can be effective in preventing or reducing overshooting of rates. Whether or not this intervention is likely to compromise domestic economic objectives (such as keeping a lid on inflation) depends on what is meant by overshooting.

One interpretation of overshooting is a variation in the exchange rate from a level which would be appropriate if market traders reacted rationally to salient economic fundamentals like relative interest rates, current accounts, underlying capital flows, fiscal deficits, net private savings, and trends in monetary aggregates. In this case, market psychology is clearly out of step with reality. The exchange rates that prevailed before the G5 initiative unmistakably fit this description. For this type of overshooting, internationally coordinated intervention to bring the market to its senses, as it were, is likely to succeed with relatively little compromise of domestic policy autonomy.

Another interpretation of overshooting is a variation in the rate from the level that would most accurately reflect the underlying competitive position of our tradeable goods sector. Dr. Bergsten's colleague, John Williamson, calls this the "fundamental equilibrium" rate and defines it as the rate which would cyclically generate current account surpluses or deficits to match underlying capital flows.

Any attempt to use FX intervention to push the dollar toward its fundamental equilibrium when it is already in step with the economic indicators outlined above could be expected to encounter resistance in the market and/or to compromise domestic economic objectives (i.e., ignite inflation).

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In other words, it would make sense as a matter of policy to use FX intervention if the exchange rate has moved out of step with key economic indicators and away from what Mr. Williamson calls its "current equilibrium". However, it would not necessarily make sense, as a matter of policy, to prescribe FX intervention to cover the final distance between the rate justified by these economic indicators and the rate reflecting a "true" measure of the international competitiveness of American goods. This distance is better covered by adjustments in government policies here and abroad to change the indicators to which the markets react. Using FX intervention in this case would be tantamount to making monetary policy either here or abroad a slave of exchange rate policy, with undesirable inflationary or deflationary consequences.

There is strong evidence that this is happening today. Three weeks ago, ten year Japanese government bonds were yielding 5.56%. Late last week they were trading at over 7%. Short term yen deposit rates have risen to over 8% while inflation remains a paltry 1%. Japanese monetary authorities are obviously compensating for rather than coordinating with American exchange rate policy (or lack thereof) with ominous implications for world trade and economic growth. The GATT Secretariat forecasts growth in world trade this year to fall to between 2% and 3% from a rate of 9% in 1984. The last thing the world economy needs now is for Japan to deflate with real rates of interest of six or seven percent!

How can Congress limit overshooting by ensuring that FX intervention and policy coordination are carried out by the Administration at appropriate times? HR 3498 and HR 3573 are worthy attempts to answer this challenge.

The FX intervention called for by HR 3498 is generally a useful short run tool which should be used in certain cases of overshooting. In the current context, this tool has already been used and, I would argue, has already largely served its limited purpose. Indeed, it should have been used long ago by the Administration. But while I would say that FX intervention should be used in similar situations in the future, I would not be prepared to say that the criteria in the bill adequately define such a situation. Depending on prevailing fundamental economic indicators, these criteria may be too loose or too tight. Indeed, I would argue that universally applicable criteria are nearly impossible for Congress to devise. The interrelationship of economic factors which determine an exchange rate's current equilibrium is too fluid and complex to be fashioned into a binding formula that would be relevant at all times.

Yet Stan Lundine is right. Considering the history of flexible rates, Congress should provide direction in the area of exchange rate policy.

Accordingly, I would suggest that the Secretary of Treasury be required to submit a report annually to this subcommittee including:

1) Administration estimates for the preceding and upcoming year of the salient economic parameters influencing the dollar's current equilibrium;

2) Estimates of the corresponding appropriate range of the dollar's current equilibrium over this period;

3) Estimates of the dollar's fundamental equilibrium over this period;

4) An analysis of the relationship between the actual market exchange rate and current and fundamental equilibria;

5) If significant discrepancies exist and/or are forseen, Administration plans to achieve convergence of these rates.

Pursuant to this report, I would suggest that this subcommittee hold a public hearing at which the Chairman of the Board of Governors of the Federal Reserve would testify. Further, I would suggest that Congress direct the Secretary of Treasury to undertake annual Article IV consultations with the International Monetary Fund, the policy conclusions of which would be made available to the subcommittee.

In addition, it should be the Sense of Congress that the Secretary and Fed Chairman will undertake to implement internationally coordinated FX intervention whenever the exchange rate varies from its current equilibrium. Finally, there could be a presumption that the Secretary shall intervene subject to the criteria in HR 3498 unless the Secretary certifies that the actual rate is not at variance with its current equilibrium.

Policy Coordination

For the time being, in my view the use of FX intervention other than to ensure that the gains of the G5 initiative are not reversed may well compromise the Fed's efforts to pursue noninflationary monetary policy. Presumably, the G5 authorities are already committed to intervene to prevent a reappreciation of the dollar.

Our focus should now be on what everyone knows is the bottom line when it comes to preventing or, in the current context, correcting an exchange rate misalignment: international policy coordination. I am sure this is what the sponsors of HR 3573 have in mind. They justifiably believe that the likely outcome of an international monetary conference would be an agreement, formal or informal, among the key trading nations aimed at keeping exchange rates more in line with the underlying competitive relationship of their tradeable goods sectors. They presumably hope that such an agreement would be the catalyst for the enhanced coordination of national economic policies on which successful meaningful international monetary reform depends. I agree, and I support their efforts.

However, they accurately characterize this as a long term strategy. Mandated unsterilized FX intervention (HR 3498) is to be the short term strategy. But, as I have mentioned, this short term strategy has already been implemented, albeit belatedly, in the G5 accord.

This leaves us with only a long term strategy to deal with a still serious immediate problem. Accordingly, I would urge the subcommittee to consider taking more direct and short term action to deal with the international macroeconomic coordination issue.

In addition to directing the Secretary of Treasury to seek annual Article IV consultations with the IMF and to submit the policy conclusions to the subcommittee, I would suggest the subcommittee to direct the Secretary to:

1) convene Phase II of the G5 initiative by regularizing (holding two or three times per year) meetings of the Versailles Group (IMF Managing Director and senior finance ministers of the G5);

2) in the context of these meetings, develop, maintain and include in the annual report to the subcommittee a medium term working agenda of macroeconomic coordination aimed particularly at maintaining general conformity of yen, deutschemark and U.S. dollar rates with their fundamental equilibria; and,

3) support within the IMF the recommendations of the Dini report regarding multilateral surveillance;

4) perform and report on a study of multilateral mechanisms to control the adverse impact of international currency substitution upon exchange rates.

Conclusion

It is difficult for Congress to formulate precise rules and prescriptions which take into account the subtle distinctions and subjective judgements involved in the day to day management of financial and currency markets. This job is better left to the Executive Branch. However, Congress can provide for the process which will ensure that problems are explicitly recognized and that corresponding policy decisions are made. That is what these suggestions are designed to accomplish with regard to both FX intervention and international policy coordination. In short, they are an attempt to institutionalize procedures to identify and to deal with currency overshooting in an era of flexibla exchange rates and high international capital mobility.

But, as the old saying goes: you can lead a horse to water . . .

Procedures are no substitute for decisions and actions. In my view, the source of the current U.S. budget stalemate is the president's obdurate refusal to work with congressional moderates of both parties to formulate a package of balanced spending reductions and revenue increases. Today, the price of his obstinacy is American jobs in tradeable goods sectors of the economy. Before long, however, that price will escalate and perhaps irreversibly erode the economic and political vitality of this country.

The world economic recovery could be prolonged several more years if U.S. budget deficit cuts permitted a worldwide reduction in interest rates and fiscal expansion in Japan, Germany and Britain. The combined stimulus of this package would more than offset the contractionary effect of deficit reduction in the U.S. It is time President Reagan follow through on his G5 return to reason.

For this reason, Title I of the omnibus bill of alternative trade legislation I introduced the other week (HR 3668) would force the president to choose between following through on G5 within a year and imposing import restrictions. It is time the Administration fully face up to the consequences of its continued recalcitrance.

Chairman **Neal**. I would like to thank our distinguished colleague for is very thoughtful testimony and very thoughtful work in this area. I very much appreciated reading the documents that he has sent around to all of our offices and I think he has made an enormous contribution. I thank you again.

At this time, we would like to hear from David Mulford, Assistant Secretary of the Treasury for International Affairs. Mr. Mulford, please if you would summarize, if you could.

STATEMENT OF HON. DAVID C. MULFORD, ASSISTANT SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS

Mr. **Mulford**. Mr. Chairman and members of the subcommittee. I welcome this opportunity to discuss efforts to improve the international monetary system and to enhance exchange rate stability in particular. The bills which you are considering generally reflect concern about the strong dollar. They propose changes in either U.S. foreign exchange market intervention operations or the international monetary system itself in order to bring about greater stability and a lower value for the dollar.

I recognize that the strong dollar has had an adverse impact on the competitive position of a number of U.S. industries. However, many of the proposed exchange rate remedies contained in these bills focus on the symptoms rather than the fundamental causes of recent problems. Such remedies are likely to be ineffective and potentially counterproductive in the absence of measures to address the underlying economic fundamentals themselves. The Treasury Department opposes both bills. The provisions contained in them are unnecessary and would impose undesirable constraints on U.S. international monetary policy.

The current international monetary system has provided a useful framework for responding to global economic shocks during the past decade. We believe the basic elements of the current system remain sound. However, the system has not been as stable as we would have liked. Increased interdependence, coupled with divergent economic performance among the major industrial countries, has contributed to large exchange rate movements and to potentially destabilizing imbalances among our economies which have fostered protectionist pressures.

There is a clear need to improve the functioning and stability of the international monetary system as an essential framework for international trade and economic growth. My written testimony outlines our thoughts on this important issue by first addressing the underlying causes of the strong dollar, which has primarily reflected the strong economic performance of the United States relative to other major industrial nations and substantially increased net capital inflows.

The LDC debt situation also contributed to a decline in U.S. exports and net commercial bank lending to debtor nations as well as capital flight to the United States. The strong dollar in turn has directly contributed in a substantial way to the deterioration in our trade balance by making our goods less price competitive abroad and foreign goods more price competitive here.

We estimate that the appreciation of the dollar may have accounted for one-third to one-half of our trade balance deterioration. The need to deal with the strong dollar has been recognized by the G–5 governments, rather dramatically in fact by the September 22 meeting of the G–5 at the Plaza Hotel in New York.

The question is what is the most realistic and effective way to deal with the problem? One point of almost universal agreement is that the strong dollar can only be dealt with effectively by influencing or changing the economic fundamentals which underlie its strength. This means we must concentrate our efforts on economic policies and performance if we are to alter in a fundamental sense exchange rate relationships in the world economy.

In concrete terms this means first, looking to disparities in economic performance among the major industrial nations as the major cause of the strong appreciation of the dollar between 1980 and 1984. Second, working with other major industrial countries to accomplish a greater convergence of favorable economic performance and, third, making the policy changes necessary to support this objective.

In the U.S. case, this will require reducing the budget deficit and creating an environment for further lowering of interest rates. Intervention is widely recognized as a policy option with only limited use over the long run as a substitute for basic economic policies for influencing long-term exchange market trends.

Conclusions very similar to these were reached by the Finance Ministers and Industrial Bank Governors of the Group of 10 industrial countries following their deputy's review and report on the current international monetary system which was released in June.

The key issue discussed by the G–10 deputies was the best means of encouraging sound policies among sovereign nations in order to achieve greater convergence toward sustained noninflationary growth.

One approach outlined by one group of deputies was a proposal for the adoption of target zones for exchange rates to be phased in progressively and to be used as a trigger for consultations on policies. The great majority of deputies, however, felt that it would be extremely difficult to agree on a range of correct and desirable exchange rates to apply for some extended period of time.

It was acknowledged that initially such target zones would probably have to be so wide as to raise questions about their utility. And there would remain the difficult task, indeed the heart of the matter; namely, allocating the burden of policy adjustment among the countries involved.

Target zones could also impose additional constraints on domestic policies which could undermine other policy objectives. This was clearly the case under the old fixed rate exchange system and one of the reasons it broke down in 1971. The probability is that a target zone system in which there was no clear agreement between countries to merge their domestic policy interests with their interests in the stability of the exchange rate system would be unsustainable.

If there were a willingness now to submerge domestic policies to international consultations between countries, we would be able to make the present exchange rate system operate more effectively than it does now, and probably would remove the need and the pressure for major changes. But, of course, there is no such willingness now evident.

On intervention, the deputies confirmed the longstanding position that intervention can be useful to counter disorderly market conditions and to reduce short-term volatility, but that it normally will be useful only when complementing and supporting other policies.

Neither capital controls nor intervention, they concluded, could be relied upon to attain lasting stability of exchange rates. The deputies therefore focused on other means of achieving this goal. There was a broad consensus that there should be close and continuing cooperation among countries to assure that countries take account of the implications of their policies and performance on others.

The deputies also agreed that international surveillance should be strengthened to improve the compatibility of policies among countries and the convergence of favorable economic performance.

They agreed that the IMF must have a central role in surveillance and made a number of recommendations to strengthen the Fund's efforts in this area which we are now pursuing in the IMF executive board. The group of five meeting in New York on September 22 reflects an important step toward putting into practice the G–10 recommendations for enhanced cooperation and compatibility policies among the five major industrial nations whose policies have the greatest impact on exchange markets.

The G–5 Ministers and Governors drew attention to the changes already occurring in economic fundamentals here and abroad; affirmed the strong prospect for continuing favorable changes in economic fundamentals; and outlined the intentions of the G–5 governments to pursue additional policies to sustain and accelerate the favorable changes.

The Ministers and Governors were convinced that improvements in underlying economic fundamentals will help to promote stronger and more balanced growth in our economies, thereby strengthening the main nondollar currencies and reducing external imbalances, including the high U.S. trade and current account deficits.

They noted that exchange markets did not fully reflect these underlying improvements and agreed for the first time that some orderly appreciation of the main nondollar currencies against the dollar was in fact desirable. They also committed to cooperate more closely to encourage this when to do so would be helpful.

The exchange market impact of the G-5 announcement reflects the market's recognition that better convergence is taking place and that the policy intentions outlined in the announcement are significant and will continue this favorable pattern.

Over half of the dollars rise against the DM between the end of 1980 and last February's peak has now been reversed, as has virtually all of the rise against the Japanese yen.

In conclusion, there is a clear need to improve the international monetary system. This will not be an overnight task. It will take some time. However, it is premature at this stage to decide whether an international monetary conference is needed. The IMF Interim Committee, which includes all IMF member countries, already has held preliminary discussions on the G-10 recommendations for improvements as well as separate recommendations prepared by the group of 24 developing nations.

The IMF executive board will now review both reports in preparation for detailed consideration at the spring meeting of the IMF interim committee. It is important that this process continue and that progress in the monetary area not be held hostage to progress on the trade side. Indeed, a number of steps have already been taken toward improving monetary stability while we are still some steps away from even beginning negotiations in a new trade round.

Secretary Baker indicated in April that the United States would be willing to consider the possible value of hosting a high-level meeting of the major countries to followup on the Group of 10's proposals on improving the international monetary system. We remain prepared to do so if at some future date such a meeting appears to be useful.

The G-5 meeting in New York represents an important step in achieving a sound world economy and a more stable international monetary system. The policy intentions announced in New York must be actively implemented and the consultation process continued.

For our part, an effective U.S. contribution to sustaining progress toward greater convergence and stability will require congressional support: To reduce the U.S. budget deficit; to pass meaningful tax reform; and to resist protectionism.

Exchange market stability can only be assured if we all do our part. The G-5 announcement must not be a one-shot effort but a continuing process of enhanced economic cooperation focusing on the underlying fundamentals.

Thank you very much, Mr. Chairman.

Chairman NEAL. Thank you, sir.

[The prepared statement of Mr. Mulford follows:]

STATEMENT OF THE HONORABLE
DAVID C. MULFORD
ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS

BEFORE THE SUBCOMMITTEE ON
INTERNATIONAL FINANCE, TRADE, AND MONETARY POLICY
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NOVEMBER 19, 1985

Mr. Chairman, Members of the Committee:

I welcome this opportunity to discuss efforts to improve the international monetary system, and to enhance exchange rate stability in particular.

The bills which you are considering generally reflect concern about the strong dollar. They propose changes in either U.S. foreign exchange market intervention operations or the international monetary system itself in order to bring about greater stability and a lower value for the dollar.

I recognize that the strong dollar has had an adverse impact on the competitive position of a number of U.S. industries. However, many of the proposed exchange rate remedies contained in these bills focus on the symptoms rather than the fundamental causes of recent problems. Such remedies are likely to be ineffective and potentially counterproductive, in the absence of measures to address the underlying economic fundamentals themselves. The Treasury Department opposes both bills. The provisions contained in them are unnecessary and would impose undesirable constraints on U.S. interternational monetary policy.

The current international monetary system has provided a useful framework for responding to global economic shocks during the past decade. Without a flexible system, adjustment to the substantial increases in oil prices and high inflation, as well as the subsequent global recession and debt crisis, would have been more difficult and probably more costly.

We believe that the basic elements of the current system, and the principles encompassed in the IMF Articles of Agreement, remain sound. Nevertheless, the current system has not been as stable as we would have liked, and we should not be complacent about the problems which exist.

The trade and capital market liberalization which has occurred during the past two decades has benefitted all of our nations and should not be reversed. As a result of these positive developments, however, our economies are also more open than ever before to external influences. Through their influence on both trade and capital flows, policies in one country can affect the ability of other governments to pursue their own domestic policy objectives.

This increased interdependence, coupled with divergent economic performance among the major industrial countries, has contributed to large exchange rate movements and to potentially destablizing imbalances among our economies which have fostered protectionist pressures. Markets have also had to adjust recently to further capital market deregulation, with which they have had little experience. This factor has also introduced an element of uncertainty in exchange markets.

There is a clear need to improve the functioning and stability of the international monetery system, as an essential framework for international trade and economic growth. This doesn't mean capital controls, nor does it require the imposition of trade barriers to isolate our economies from the external world. Such measures are damaging to ourselves as well as to others and merely bring on retaliation in kind.

A more positive approach to greater stability is needed. I would like to outline our thoughts on this important issue by first addressing the underlying causes of the strong dollar and the lessons to be learned from recent exchange market developments. I will then discuss the implications of this experience for current efforts to improve the functioning of the international monetary system.

Causes of the Strong Dollar

Our analysis indicates that while there is a complex and multifaceted relationship between the strength of the dollar and the trade deficit, two fundamental factors stand out:

-- strong economic performance in the U.S. relative to other major industrial countries; and

-- the LDC debt situation.

A. Disparities in Economic Performance

The vigorous U.S. expansion, and our strong gains in employment since 1982, contrast with the relatively weak performance of our trading partners over the period of dollar appreciation, mid-1980 to end-February 1985.

For example, at the end of 1984 industrial production in the United States was 11 percent higher than it was 4 years earlier, despite a year long recession in 1982. In contrast, industrial production in Europe at the end of 1984 was essentially unchanged from its 1980 level. There have also been stark performance differences in a broader measure of output -- our real GNP in the fourth quarter of 1984 was 12 percent higher than during the recession's trough in 1982. Real GNP in the other major industrial countries rose only 7 percent over the same period and, in Europe alone, only 4 percent.

This was a reversal of historical trends. During the Sixties, the U.S. economy grew more slowly than the other major nations, with an average annual growth rate of about 4 percent, as compared to more than 6 percent for other industrial countries. During the Seventies, this growth gap narrowed to less than 1 percentage point, although the United States still grew more slowly. During 1982-84, however, our relative growth rates reversed: we grew at an average 5.3 percent, nearly double the average growth rate of other industrial nations.

U.S. inflation performance also improved markedly relative to Europe between 1930 and 1984. The U.S. inflation rate fell from more than 13 percent in 1980 to slightly more than 4 percent in 1984, an improvement of over 9 percentage points. Inflation in the four major European countries fell from an average of about 13 percent in 1980 to about 6 percent in 1984, an improvement of 7 percentage points.

Why has U.S. performance been so strong relative to Europe in particular? The answer is found in the economic policies pursued by the Administration and Congress over the past five years. Anti-inflation efforts, deregulation, tax reductions, and a shift both in attitude and behavior towards free markets stimulated investment and increased rates of return to entrepreneurship. The dynamic and flexible environment produced by these policies is reflected in the creation of over 8-1/2 million jobs during the current expansion.

By contrast, European growth and job creation have been hampered by policies that have limited their economies' ability to adapt to changing economic circumstances. For example, an array of hiring and firing regulations and generous unemployment benefits have raised the cost to firms of taking on new workers and reduced the desire of workers to seek new jobs. Europe lost over half a million jobs during 1982-84 -- at a time of positive growth.

These differences in economic performance have had a strong impact on the trade balance and the dollar over the past five years:

- -- Stronger U.S. growth relative to our major trading partners resulted in strong U.S. import growth and weak export growth. As a rule of thumb, each one percent of U.S. GNP growth raises our imports by $10 billion; each one percent of growth by the other countries increases U.S. exports by $5 billion.

- -- U.S. investors looked at our strong economic performance, our stable political environment and our high after-tax real rate of return on investment, in both absolute terms and relative to other countries, and decided to keep their money at home. Foreign investors found dollar assets attractive for similar reasons, and increased their investments in the U.S. Strong net capital inflows to the United States contributed to the appreciation of the dollar.

B. LDC Debt Situation

The LDC debt situation was also a major element in both the strong dollar and our trade deficit. In 1980, the non-OPEC LDCs accounted for nearly 30 percent of our exports. But as their external and domestic economic conditions deteriorated with the emergence of the international debt problem, their economic growth fell sharply. As a result, our exports to all non-OPEC LDCs in 1984 were about $7 billion below the 1981 level.

These effects of the debt situation also contributed to the stronger dollar, through its impact on the U.S. capital account. Between 1982 and 1984, net U.S. commercial bank lending swung from an outflow of $45 billion to an inflow of $23 billion. This large swing reflected in part the preference of U.S. banks to lend domestically rather than to LDCs after the debt problem emerged late in 1982.

It is also likely that the sizable difference between recorded U.S. net capital inflows and our current account deficit primarily reflects unrecorded capital flows from the developing world to the U.S. -- the safe haven factor. Poor domestic economic performance and a general lack of confidence in economic policies encouraged domestic investors in LDCs to send their money abroad.

C. The Strong Dollar and the Trade Deficit

Up to this point, I have treated the trade deficit and the strong dollar as separate phenomena, both reflecting the common underlying factors of disparities in performance and the LDC debt situation. This is the basic fact which has guided our response to the problem posed by the strong dollar and the trade deficit.

However, I recognize that the strong dollar, in turn, has directly contributed in a substantial way to the deterioration in our trade balance by making our goods less price competitive abroad and foreign goods more price competitive here. We estimate that the appreciation of the dollar may have accounted for one third to one half of our trade balance deterioration.

The need to deal with the strong dollar has been recognized by the G-5 Governments, rather dramatically in fact by the September 22 meeting of the G-5 at the Plaza Hotel in New York. The question is: what is the most realistic and effective way to deal with the problem? One point of very wide, indeed almost universal agreement, is that the strong dollar can only be dealt with effectively by influencing or changing the economic fundamentals which underly its strength. This means we must concentrate our efforts on economic policies and performance if we are to alter in a fundamental sense exchange rate relationships in the world economy. In concrete terms, this means:

(1) Looking to disparities in economic performance among the major industrial nations as the major cause of the strong appreciation of the dollar between 1980 and 1984;

(2) Working with other major industrial countries to accomplish a greater convergence of favorable performance; and

(3) Making the policy changes necessary to support this objective. In the U.S. case, this will require reducing the budget deficit, and creating an environment for the further lowering of interest rates.

As for intervention, it is widely recognized as a policy option with only limited use over the long run as a substitute for basic economic policies for influencing long-term exchange market trends.

Conclusions very similar to these were reached by the Finance Ministers and Central Bank Governors of the Group of Ten industrial countries, following their Deputies' review and report on the current international monetary system, which was released in June. The G-10 report emphasizes the importance of international cooperation, the adoption of sound domestic policies, and a convergence of economic performance as prerequisites for greater exchange rate stability.

The report took two years to produce and received the attention of several of the world's most experienced financial market people. The key issue discussed by the G-10 Deputies was the best means of encouraging sound policies among sovereign nations which result in convergence toward sustained non-inflationary growth. One approach outlined by one group of Deputies was a proposal for the adoption of target zones for exchange rates, to be phased in progressively and to be used as a trigger for consultations on policies.

The great majority, however, felt that it would be extremely difficult to agree on a range of correct and desirable exchange rates to apply for some extended period of time. It was acknowledged that initially, such target zones would probably have to be so wide as to raise questions about their utility; and there would remain the difficult task, indeed the heart of the matter, namely allocating the burden of policy adjustment among the countries involved. Target zones could also impose additional constraints on domestic policies which could undermine other policy objectives. This was clearly the case under the old fixed exchange rate system and one of the reasons it broke down in 1971.

The probability is that a target zone system in which there was no clear agreement between countries to merge their domestic policy interests with their interests in the stability of the exchange rate system would be unsustainable. If there were a willingness now to submerge domestic policies to international consultations between countries, we would be able to make the present exchange rate system operate more effectively than it now does and probably would remove the pressures for major change. But, of course, there is not such a willingness now evident.

On intervention, the Deputies confirmed the long-standing position that intervention can be useful to counter disorderly market conditions and to reduce short-term volatility, but that it normally will be useful only when complementing and supporting other policies. Neither capital controls nor intervention, they concluded, could be relied upon to attain lasting stability of exchange rates.

The Deputies therefore focussed on other means of achieving this goal. There was a broad consensus that there should be close and continuing cooperation among countries to ensure that countries take account of the implications of their policies and performance on others. The Deputies also agreed that international surveillance should be strengthened to improve the sound policies and the convergence of favorable economic performance, and put forward a number of proposals to strengthen IMF surveillance. The IMF must be at the center of efforts to improve the international monetary system and we believe there is considerable potential for a strengthening of IMF surveillance in order to encourage sound policies in member countries. We will be pursuing the recommendations of the G-10 Deputies further within the IMF Executive Board in the months ahead.

The specific measures proposed by the G-10 report to accomplish these objectives are modest, but sound ones and represent a solid basis on which to build for the future as we continue our efforts to strengthen the system. However, as Secretary Baker indicated in Tokyo in June, this shouldn't be the end of the road.

Greater monetary stability can only be achieved if each nation develops the political will to tackle the difficult problems it faces -- and is supported both at home and by comparable actions by the other key nations.

The Group of Five's meeting in New York on September 22 reflects an important step toward putting into practice the G-10 recommendations for enhanced cooperation and compatible policies among the five major industrial nations whose policies have the greatest impact on exchange markets. This is the real message behind the New York Announcement, and one that it will be essential to maintain in the months ahead. In light of the major importance of this meeting, I would like to discuss it in some detail.

The G-5 Announcement

After the G-10 meeting in Tokyo, we became convinced that concrete measures were needed to follow up on the discussions in Tokyo. While the G-10 report would be referred to the IMF Interim Committee for broader review and discussion, earlier action was also needed to address underlying policies in order to help improve exchange market stability.

After considerable preparation, the Group of Five therefore met to discuss economic development and policies in their countries and their implications for economic performance and prospects. The G-5 recognized the serious dangers posed by rising protectionist pressures and focused discussion on factors contributing to large external imbalances. These include growth differentials, exchange rate movements, differing degrees of market openness and the LDC debt situation.

The G-5 Finance Ministers and Central Bank Governors noted that economic fundamentals in all of the countries are moving in the direction necessary to foster adjustment of external imbalances. For example,

- After very rapid growth last year, the U.S. economy slowed in the first half of 1985 and is now growing at a more moderate, sustainable rate;
- Growth in other major industrial countries is strengthening and is becoming more balanced between domestic and export-led components.

This improved performance is the result of policy changes already undertaken in a number of countries over the past year or two, a fact clearly highlighted in the G-5 announcement. The G-5 Governments also agreed to pursue additional policies to sustain and accelerate these favorable changes in the future. These policy intentions reflect widespread agreement that convergence of economic policies and performance is the best basis for stability in exchange rate relationships.

The Ministers and Governors were convinced that improvements in underlying economic fundamentals will help to promote stronger and more balanced growth in our economies, thereby strengthening the main non-dollar currencies and reducing external imbalances, including the high U.S. trade and current account deficits. They noted that exchange markets did not fully reflect these underlying improvements and agreed, for the first time, that some orderly appreciation of the main non-dollar currencies against the dollar was in fact desirable. They also committed to cooperate more closely to encourage this when to do so would be helpful.

The G-5 announcement and subsequent actions by the G-5 Governments have helped to improve market recognition of the recent and prospective changes in underlying policies and performance. Intervention has been useful in this process precisely because it has been supported by changes in underlying performance and policies, confirming our basic view that intervention alone cannot have lasting effects on exchange rates.

The exchange market impact of the G-5 announcement reflects the market's recognition that better convergence is taking place and that the policy intentions outlined in the announcement are significant and will continue this favorable pattern. Since September 22 the dollar has fallen, under generally orderly conditions, an additional 9 percent against the DM and French franc, over 16 percent against the yen and 5 percent against sterling. Over half of the dollar's rise against the DM between the end of 1980 and last February's peak has now been reversed, as has virtually all of the rise against the yen. The initial impact of the G-5 announcement therefore has continued and remains positive.

I believe that as time passes awareness of the relationship between economic fundamentals and exchange market behavior will establish itself more firmly. This should provide greater long-term stability in exchange markets, provided that major countries can continue to improve and strengthen the consultative process necessary in international economic matters.

Conclusion

In conclusion, there is a clear need to improve the international monetary system. This will not be an overnight task. It will take some time.

However, it is premature at this stage to decide whether an international monetary conference is needed. The IMF Interim Committee, which includes all IMF member countries, already has held preliminary discussions on the G-10 recommendations for improvements, as well as separate recommendations prepared by the Group of 24 developing nations. The IMF Executive Board will now review both reports in preparation for detailed consideration at the spring meeting of the IMF Interim Committee.

It is important that this process continue, and that progress in the monetary area not be held hostage to progress on the trade side. Indeed, a number of steps have already been taken toward improving monetary stability, while we are still some steps away from even beginning negotiations in a new trade round.

Secretary Baker indicated in April that the United States would be willing to consider the possible value of hosting a high-level meeting of the major industrial countries to follow up on the Group of Ten's proposals on improving the international monetary system. We remain prepared to do so if at some future date such a meeting appears to be useful.

The G-5 meeting in New York represents an important step in achieving a sound world economy and a more stable international monetary system. The policy intentions announced in New York must be actively implemented, and the consultation process continued. For our part, an effective U.S. contribution to sustaining progress toward greater convergence and stability will require Congressional support:

-- to reduce the U.S. budget deficit;

-- to pass meaningful tax reform; and

-- to resist protectionism.

Exchange market stability can only be assured if we all do our part. The G-5 announcement must not be a one-shot effort, but a continuing process of enhanced economic cooperation focusing on the underlying fundamentals.

Chairman **Neal**. Let me say—this is clearly an opinion—clearly these bills and others, including a number of protectionist bills that are gaining in favor, are the result of events over the last 4 years which have had very disastrous consequences on a number of sectors of our economy, and if not altered, will do a whole lot more damage in the future.

I share very strongly the frustration of what I sense to be the frustration of Mr. Lundine and many others about this situation, and I have already expressed my concern about these bills.

My concern is that they would do more harm than good, but I certainly want to say I share in the concern about these macroeconomic policies that we have been following and certainly hope that we can alter them significantly in the future.

Mr. LaFalce.

Mr. **LaFalce**. Thank you, Mr. Chairman.

Mr. Mulford, I want to praise you for the job that you have done in Treasury in that position since you took over.

Mr. **Mulford**. Thank you.

Mr. **LaFalce**. You were heralded in the Wall Street Journal recently and you certainly deserve the acclaim you received there.

Therefore, your opinion is of special import to me and I suspect all the members of the subcommittee.

You are not necessarily opposed to an international monetary conference, correct? You said that at some appropriate time, it might be highly desirable.

Mr. **Mulford**. Yes, I think in principle it may be necessary or desirable at some time, but that it is premature at this time.

There is a process already working which I think we should follow.

Mr. **LaFalce**. OK. So then your opposition would be either to the legislative mandate itself or to the legislative mandate that it be done now.

Suppose there were some legislative mandate but we left the timing of it to the discretion of the administration?

Mr. **Mulford**. Well, I think the difficulty is that process is now underway. I have outlined that process in my comments; it involves on the one hand, the G-5, and on the other hand, the Interim Committee, which at this time is preparing for discussions next spring on the G-10 and G-24 submissions, is a process which may lead to sufficient improvement of the system to make unnecessary in the long run a major international monetary conference.

So I don't think there needs to be a specific order that there must be one.

Mr. **LaFalce**. Of course, if we left it to the discretion of the administration, we would establish the sense of Congress at least that the President should have one at his discretion depending on certain things, which might buttress your attempts to have an effective process.

Speaking of the process, however, I think there are a number of difficulties with the process. First of all, it has not been a very visible process.

Second, it has not been a very accountable process. I don't believe that the Members of the Congress have been that well appraised of the process. Maybe I am wrong, but to my knowledge, that is true.

Third, I don't know how long that process has been going on, but uncertainty exists given the changes that have taken place in the administration, the changes that could take place tomorrow. You might be replaced tomorrow and we would have a switch of Don Regan and Jim Baker once again; Beryl Sprinkle could come back to Treasury and you could go to the Council of Economic Advisers. And, to tell you the truth, because personnel changes have had so much to do with policy changes, I seriously believe that Congress ought to attempt to work more aggressively, either through legislation or through oversight or a combination of the two, with the administration on processes as well as product.

So, having said that, let me just get a gut reaction to an approach that would first establish a temporary U.S. Commission on International Monetary Reform. The Secretary of the Treasury could participate in a conference such as here last week. There ought not to be any opposition to commission an international monetary reform commission. Whereas in February 1983, I introduced a bill creating a commission on industrial competitiveness, the administration said no, then they created one in July by executive order.

Maybe we need a commission right now on international monetary reform as a preliminary step, some legislative mandate that the President work through the IMF as you are presently doing, through the ministerial working group, which could consider, among other things, the agenda suggested by the commission that would be created in preparation for some appropriately defined and appropriately timed international monetary conference.

How do those bounce off you?

Mr. **Mulford**. Well, I believe that the things that you are——

Mr. **LaFalce**. Say whatever you want, but don't say no.

Mr. **Mulford**. I believe the things you are after in your proposals are already taking place and that, therefore, the proposals are in a sense being overtaken by events.

Now, one of your concerns is to ensure that the process continues. That is one of your concerns.

Mr. **LaFalce**. The concern I have, David, is that a lot of this in my judgment may well have been done, probably was done, at least in part, as a means of stemming the protectionist fervor within the U.S. Congress.

The timing vis-a-vis the textile bill was unbelievable—right before the textile vote, I think it worked. The textile bill passed the House and passed the Senate, but passed with a majority, not two-thirds, so now the President realizes he has the ability to sustain any veto—I should not say any veto, but if he could sustain it on textile, he probably could sustain a veto on most anything.

I am not now as sanguine that we will proceed apace with what we started out with in G-5, the $300 million war chest, the Baker initiative with the Third World debt, et cetera.

Mr. **Mulford**. Well, you are asking a very important question and that is how we keep the momentum going, and so on.

I would like to go back and try to answer one question which you asked, which I think needs to be understood, and that is that the

G-10 study, which was completed in June this year and submitted to the ministers in Tokyo at the G-10 ministerial meeting, was a study that took about 2 years to do. It is a very, very complex subject, and it may have taken a little longer than it should have, but it really is a process that takes a very long time when you get a group of 10 countries and a few others together and go through a field like that.

But I believe that was a very, very important process because it established what I believe to be fairly universally accepted today, that although we have problems in our system, there is not a strong case for returning to a fixed exchange rate system of the type we had. There are people who pine after that.

That is a very important point to have established. I think that the completion of that process in June signaled the time when something more could be done about the strong dollar.

Obviously timing was important, as you point out. But I don't think much could have happened before that because of the G-10 process and also the economic fundamentals were not right.

It wouldn't have made sense to do a G-5 operation as was done in September a year earlier in the face of a strongly rising dollar with the economic fundamentals——

Mr. **LaFalce**. Intervention might work temporarily if it is flowing with the tide, but if it is flowing against it, you got——

Mr. **Mulford**. I don't think intervention would have been effective at all earlier.

Mr. **LaFalce**. Right.

Chairman Neal has asked why we need a strategic currency reserves. We already have an exchange stabilization fund. If we have a stabilization fund which can serve those purposes, and you certainly are for that exchange stabilization fund, then you wouldn't be conceptually against a strategic currency reserve.

Mr. **Mulford**. But for the fact it is not needed.

Mr. **LaFalce**. You say it is already there.

Two questions would flow from that. Is there some advantage or disadvantage in having a strategic currency reserve separate from the exchange stabilization fund, point No. 1.

No. 2, if there is no merit to it, if there is a disadvantage to it, either way, what ought the size of the fund be? That is a crucial question, too, and how would that fund receive its financing.

Mr. **Mulford**. To your first point, I don't think there is any case to establish a second strategic fund because the exchange stabilization fund is perfectly adequate to the task at hand. And it will be in the future, and it is adequately funded.

We don't see any problem there at all. I think the creation of an additional fund poses some problems that Chairman Neal has already touched on.

Mr. **LaFalce**. What is its funding?

Mr. **Mulford**. It has about $12.5 billion, I think. I don't have the figures right handy. We can give them to you.

The various kinds of assets were cited by Chairman Neal, in value. But there is an adequate resource there for intervention purposes.

Mr. **LaFalce**. About how much have we used since G-5 Sunday?

Mr. **Mulford**. We don't comment in detail on intervention operations. We do, as you know, go through a process of informing this subcommittee on a monthly basis, and that has been done and will be done.

Mr. **LaFalce**. What about the consent of requiring greater accountability on the part of the President and the Treasury regarding the G-5, G-10 processes, the OECD processes and the intervention processes.

You say you are already advising the chairman on a monthly basis, I gather.

Mr. **Mulford**. There is a formal letter that is produced by the Treasury each month on this question which serves as a report in a sense that is sent up to the committee, and that goes on all the time, and has in it the data that you have asked for.

Mr. **LaFalce**. One of the things I am considering, too, in legislation is requiring periodic reporting and then the question is, what precisely it is that should be reported. I want to make it something that is not unduly burdensome. I want it to be helpful.

Mr. **Mulford**. Again, I think the present system works pretty well. Since September 22, the Secretary has appeared, I have appeared a number of times before various committees. There has been briefings carried out and so on.

Mr. **LaFalce**. We have a history, David, that goes beyond the past 2 months. If we had had periodic reporting, for example, required from 1980 to 1984, somehow I suspect that we would have gotten greater action before September.

Mr. **Mulford**. There has been periodic testimony on all these subjects at all times, so that has been an ongoing process. There has been no failure to provide an explanation to Congress of the administration's policies, thoughts and developments on exchange rate questions. There has been a steady flow of exchange on this subject over the period you mentioned.

Mr. **LaFalce**. Thank you.

Chairman **Neal**. That report is available to any subcommittee member. It is a confidential report.

Mr. Levin.

Mr. **Levin**. You know, the discussion here has some echoes with Gramm-Rudman. The question in part, any way, is whether there should be some kind of trigger or whether it should be left up to flexible processes, in this case, within the executive. And at the very least as the chairman said, Stan Lundine and Don Pease and others of us who have been worried about this have, I think, helped to spark a response from the administration.

When I read on page 9 that action is necessary to resist protectionism, there is an irony in that I think so-called protectionism helped to spark the action of the administration. So you come here asking us to resist one of the things that helped your being here. Let me just pursue it a bit further, this question of whether there should be some triggers. In Stan Lundine's bill there are some mechanisms that are put into place and some requirements.

You are maybe not the best person to comment on this, but you already have, talking about the work that took a couple of years, and I really didn't fully understand your conclusion. You are essentially saying that no action would have been feasible a year and a half ago. I don't understand why that is why currency intervention was effective, legitimate, feasible a month ago, but not 13 months ago.

I think that underlies in part the proposal to come forth. I don't understand——

Mr. **Mulford**. What I meant by that was an exercise of the type that was done in September would not have been feasible earlier in my opinion because the economic fundamentals were not correct for the carrying out of such an operation. Let me give a little more detail on that.

During the course of 1985, we saw important changes taking place in the fundamentals. U.S. economic growth had slowed down, moderated and was on a more sustained path at a substantially lower level than had been the case previously, and growth in the other major industrial countries had picked up so that the great discrepancy which existed in the previous period between U.S. growth running at, say, 7 to 8 percent on the one hand, and growth in our major industrial trading partners, members of the G–5 running at substantially lower levels, in the 1½- to 2-percent range, has been dissipated by 1985.

Their growth had picked up and was no longer so heavily influenced by an export led growth. It was a growth that was based on a more substantial domestic demand component. These were important changes which the exchange markets had already begun to recognize. If you are looking at the situation as we looked at it in September, however, the judgment was made that the change in economic fundamentals were not at that time fully reflected in the exchange markets, and that was a very important conclusion which was made in a document which was released publicly.

In view of that, it was agreed by all participants that it would be desirable to see the nondollar currencies rise against the dollar, and they were willing to act in a cooperative fashion to help that process along. Those are very important conclusions. Now, a year earlier, with the huge divergence in economic performance of the countries and with a very strong dollar, based on those fundamentals, to simply try to agree on a program that might involve a measure of coordinated intervention in the face of that strength would have been, I think, not a productive exercise because that would not have been in line with the changing fundamentals at that time. They were moving in the opposite direction.

Mr. **Levin**. I think this gets to at least part of the issue, the extent to which intervention would have been artificial 13 months ago. I will have to go back and remind myself of the figures. I don't think we had 7- to 8-percent growth here 13 months ago.

Mr. **Mulford**. We had concluded a period of very high growth.

Mr. **Levin**. Well, that's—with all due respect—fancy language. I mean concluded—what was the rate of economic growth in the United States 13 months ago?

Mr. **Mulford**. I can't give it to you off the top of my head, but I can tell you by summer of 1985 the trends were clearly there for the change I have described, and——

Mr. **Levin**. The question is how much we can affect the trends, though, by this mechanism, and the way you describe it is that it is completely the caboose. Any kind of intervention only can come into effect and be productive when everything else is in place. And I would suggest that the experience has been somewhat to the contrary.

First of all, I think it came far after these factors had changed. And, second, I think we have seen within Japan the currency—a change has sparked or may spark—I should be cautious—the Japanese to take other steps to sustain the change, including alterations of their domestic policies.

I would like to go back and look at—and maybe it will come up in other testimony, what these basic—what these fundamentals were 13 months ago. I don't think they were so different than they were a month ago.

Mr. **Mulford**. They are very different. They were roughly as I have outlined.

Mr. **Levin**. Seven to eight percent.

Mr. **Mulford**. We had concluded a period of very rapid growth. We can give you the detailed numbers in writing if you wish.

Mr. **Levin**. Gross national product, third quarter of 1984, 1.6, 4.3, 0.3, 1.9—I don't—those figures don't come anywhere close to 7.8. The last 7-percent increase was the second quarter of 1984.

We are now talking about—this is October of 1985 the actions were undertaken, right?

Mr. **Mulford**. September.

Mr. **Levin**. The cases—I must say, it casts a major shadow over your position, and I think it throws an important gloss of validity to the basic thrust of what is in the proposal. Forget for a moment details, important questions of implementation. I don't understand the 12-month gap.

Mr. **Mulford**. Let me just try—I do have some aggregate numbers here that I think also make the same point. Let me just read you from a section of the testimony that was submitted in writing:

> The United States real GNP in fourth quarter of 1984 was 12 percent higher than during the recession's trough in 1982.

Mr. **Levin**. What page?

Mr. **Mulford**. Page 3:

> . . . 12 percent higher than during the recession's trough in 1982. Real GNP in the other major industrial countries rose only 7 percent over the same period, and if you take Europe alone, GNP growth was only 4 percent.

What we are interested in here is the very substantial difference between U.S. growth on the one hand and growth in these other countries. Then later, again another number, during 1982-84, U.S. relative growth rates reversed. We grew at an average of 5.3 percent, nearly double the average growth rate of other industrial nations. That is the aggregate in growth rate, and that is a reversal from previous performance on the part of the United States.

Now, when you get a substantial difference like that in relative growth rates, that has been a contributive factor to the strength of the dollar. In 1985, those patterns have completely altered, and, for example, the present projections for this year are a growth rate for the United States of something in the area of 2½ to 3 percent. Japan is looking for a growth rate of something like 4.6 percent.

Germany is at about 2.8 percent, so you see a much greater sort of convergence of performance.

Mr. **Levin**. What was the Japanese growth rate in 1983 and 1984?

Mr. **Mulford**. I don't have that number, but their growth rate this year is 4.6 percent expected for the present year.

Mr. **Levin**. I just want to say that I don't think your figures, by comparing 1984 with the trough of the recession, I don't see that it gets at the gist of this argument. And, also, I think the problem is that the administration came forth with an argument about nonintervention a year ago.

As I remember it, it wasn't the discrepancy in the figures, it was the evil of interventionism. That was the case. It was theology, not statistics that were given to us.

Mr. **Mulford**. Let me just make a response to that. First of all——

Mr. **Levin**. Ideology.

Mr. **Mulford**. It is widely agreed that the intervention which does not reinforce economic fundamentals, and, in fact, may run contrary to them, is not going to be effective. And as to the question of theology, well, I am not myself a theologian.

Mr. **Levin**. One reason you are more effective in this area.

Mr. **Mulford**. The third point I would make on the question of timing is although you look at the date of September 22, it did take a number of months to negotiate those arguments so that one can date recognition of this need in an effort to make these changes to May 1985.

Mr. **Levin**. You know, the comment of many American business people that I have read is after the action of intervention was very supportive of the urge that it should have had the year before, and one of the reasons—it is not the only one. One of the reasons, as you know, for an effort to build some kind of standard, if not automatic action, some kind of guarantee into the legislation, that effort in this area is reflected by the action with the domestic deficit.

And I think it has to be fully understood, and while you fight it, I think, No. 1, it is important to recognize the source of the reason for it, and, No. 2, it might be better if you could work with us to see if there are some kinds of additional structures that can be built into this process.

Because essentially—and this is where I will conclude—your plea is "Trust us." I remember a political button back in 1972, and it was "Trust me." Everybody wore it and without anybody else's name on it, it was just, "Trust me." Essentially, I mean, I could pull out that button and put it on your lapel, and that is essentially what you are saying, "Trust us."

And I guess we have to say in response, "We respect you, and we are glad you are now on this course." But that kind of—there hasn't been the foundation for that kind of trust, not only within the Congress, but in the public at large, and we would like to write into law, or we would like to talk about some kind of greater guarantee than the slogan, "Trust us."

Chairman **Neal**. I take it this policy hasn't been run with Jerry Falwell's approval.

Mr. Lundine, may I also point out, it looks like we are going to run into a time problem. We have another distinguished panel we would like to hear from. It is now 11:15. I am prepared to stay all day, myself, but not everyone may want to do that. I will call on Mr. Lundine.

Mr. LUNDINE. Thank you, Mr. Chairman. Thank you for your courtesy. I will try to be brief. I would like to start where Mr. Levin ended up, but I would just like to ask the general question: What role do you think Congress ought to have with respect to setting policy on exchange rates or on questions of international monetary reform?

Mr. MULFORD. Well, I think responsibility in the first instance, for both those areas lie with the Secretary of Treasury, and clearly the initial process has to concern him, it seems to me, to be effective, and Congress' role is one of review and consultation.

Mr. LUNDINE. Not policymaking?

Mr. MULFORD. Policymaking if necessary. And there are evidences that already are present of past congressional policymaking, which has resulted in certain of the tools and procedures, et cetera, that we use, such as the exchange stabilization program. So I think it is a mixed and cooperative venture, but I don't think it is possible to, in the congressional process, attempt to legislate on a constant basis for the development of the international monetary system.

I don't think that is an attractive proposition.

Mr. LUNDINE. How long do you think we could go on running trade deficits of more than $100 billion without a crash in the value of the dollar and resurgence of inflation and interest rates? How many years could we sustain this kind of trade deficit?

Mr. MULFORD. I don't think there is any way to make a judgment on that question as precise as you are asking. Obviously, we have recognized the problem. We are working to alleviate it. It will take some time. I think we do have some time. We also have a very large budget deficit problem which is going to take time, which also must be resolved for your own domestic reasons, and that is another enterprise which is being looked at over a period of time.

Mr. LUNDINE. Right now we are estimating with the President and the Congress as well, informally, that it will take us 5 years to get to a balanced budget. If we ran trade deficits of this magnitude for another 5 years, do you think that is sustainable?

Mr. MULFORD. Well, I don't see why the trade deficit should run at the present level for the next 5 years. We have already seen a substantial adjustment in currency value since the peak was reached in February.

Mr. LUNDINE. We haven't seen a reduction in the trade deficit.

Mr. MULFORD. It will take time. There is since September a 10 percent further adjustment. Our estimate is that a 10-percent decline in the dollar will eventually work through to about a $30 billion impact on our trade deficit, in something like 18 months to 2 years later.

If you look at present levels against the peak levels reached in February, we have in a sense avoided an even worse trade deficit situation than we might have seen, and will see improvement from the recently established levels by virtue of the change taking place since the G-5 in September.

Also, our trade deficit is influenced by growth in our trading partners, so another rule-of-thumb estimate we use is a 1-percent increase in growth in our main trading partners generally will work through in a similar way to about a $5 billion impact on the trade deficit.

So taking what is happening since September, you might look for a substantial shift 18 months or 2 years from now, and this will be a process that in our opinion will be continuing. Now, it is also possible to alter exchange rates by damaging our economic performance, returning to inflation, high interest rates, low growth, stagnation, et cetera, and completely ruining our economic well-being in order to produce a lower dollar, but that is not a practical option, and I don't think anybody here would advocate that.

What we are trying to do is maintain reasonable economic performance, encourage greater performance on the part of our trading partners and work in the ways that we are working to produce some solution to the strong dollar.

Mr. **Lundine**. Since my time is limited, I am going to go on to another subject. How can the G-5 initiative be adequate in terms of intervention when it doesn't even include our largest trading partner, Canada? And, second, you cited the tremendous progress we have made with respect to the dollar/yen relationship.

Are you satisfied that the Germans are as well collaborating, and are you satisfied with the progress on the mark as well as the yen?

Mr. **Mulford**. Canada, I think, is a special situation because of their relationship with us, and they run their currency at a level that is in fact pegged to the United States level. They are not a participant in the G-5 exercise and therefore the operation of their currency market is not fully relevant to course of exchange rates among the G-5. So I think it is quite right to put that to one side.

On the question of Japan, we believe that the yen has appreciated very sharply because Japan has indicated that it is making changes. On October 15 it announced a package of measures to further increase domestic growth. There has also been for the past 2 years ongoing discussions with the Japanese on the yen/dollar, which is, as you know, aimed at the reform and deregulation of their financial system and the internationalization of yen.

In my opinion, when these changes began to occur, one of the reasons the rise in the yen was stronger was that there had been a good groundwork laid for it in all these various ways.

Mr. **Lundine**. My question is what about the mark?

Mr. **Mulford**. On the question of the mark, we are not satisfied with the German response. We believe they have been the least responsive of the five countries. We think they could do more. We have encouraged them to do more to increase domestic growth without pump priming measures and inflation, and so on, and we hope that they will continue to review their situation and make a greater contribution.

The deutsche mark has made some adjustment, but it has not been as substantial as the yen.

Mr. **Lundine**. Thank you very much.

Mr. **LaFalce**. One question: Stan brought up the question of the Canadian dollar. What has that done since September 22?

Mr. **Mulford**. That has stayed——

Mr. LaFalce. It has stayed roughly the same?

Mr. Mulford. The same. And they keep it there by their own market operation. Sometimes they are buying and sometimes they are selling, and they peg themselves to our rate.

Mr. LaFalce. As a border Congressman representing—I have four bridges in my district to Canada. I am well aware of the fact while our trade deficit with Japan is approaching $50 billion, our trade deficit with Canada is in excess of $25 billion, and they have about 25 million people. There is a considerable amount of talk right now about a free trade zone between the United States and Canada. But you can discuss free trade zones without discussing the appropriate relationship between our respective dollars.

It would be foolish on our part at least at this juncture. Maybe that is something we ought to discuss in the future, what we should do about that, since it is in a certain sense——

Mr. Mulford. We would be happy to respond to you in writing on that question.

Chairman Neal. Thank you very much for being with us this morning.

At this time, we would like to call our second panel, comprised of C. Fred Bergsten, director, Institute for International Economics; William Niskanen, president of the CATO Institute, former member of Council of Economic Advisers, Lawrence A. Fox, National Association of Manufacturers. I welcome this distinguished panel this morning. Without objection, we will put your entire statements in the record.

I would ask you to summarize if you can. We would like to have a little more time for questions and answers. We would like to start with Fred Bergsten.

STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. Bergsten. Thank you. I won't dwell on the problem of the strong dollar and trade deficit. You all know about that. That is the source of this hearing this morning. I would start with a word or two on where we stand today after the initiative of September 22, taken by G–5 that you were discussing with the earlier panel.

I think the key point to make is that there has been a lot of progress, but that we are still in a situation where the U.S. current account balance can be expected to deteriorate further and reach even more unmanageable levels over the next 5 years.

By our calculations, the dollar earlier this year, when it peaked, was about 40 percent overvalued in terms of the trade competitiveness that you referred to earlier. The decline since that time means the dollar is now overvalued by only 25 percent, but that still places us on a course where the current account deficit will continue to rise, and by 1990 will reach $250 billion in that one single year.

In short, the situation is less bad than it was 8 or 10 months ago, but it is still unbelievably bad, will continue to be a drag on our economy, will continue to push protectionist measures in this body, will push the United States to be the world's largest net debtor

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country, in excess of a trillion dollars, and still require enormous further attention to get anything like a responsible correction.

Now, on the analyses we have done at my institute, some of which have been published and more will be published in the next few weeks, we would believe that a further major adjustment of the exchange rates is the key measure. We would have to go to at least a dollar/yen rate in the 180 to 190 range, and would have to carry the deutsche mark to at least 2.2 to 1.

Those rates compare with the current yen rate of over 200, so it is not too great a further advance on the yen. It would mean a move of perhaps another 20 percent on the deutsche mark rate and the rates of the other European currencies clustered around the deutsche mark in the European monetary system.

So, in short, there is still a long way to go. As I read the two bills before the committee today, promoting that further adjustment is one of their basic purposes. Indeed, in the short run, I think that is their basic purpose, and therefore the objective of the bills deserves strong support.

Now, one must point out that this present currency misalignment is only the most recent and most dramatic of a seemingly endemic series of misalignments that have occurred since the major currencies were floated over 12 years ago.

In the late seventies, the dollar dropped to unrealistically low levels, and that caused additional inflationary pressure in our economy. So, in addition to correcting the present misalignment, there is a need to improve the functioning of the international monetary system in order to avoid large trade imbalances.

In my view the most promising technique is to create a regime of target zones within which the major countries would agree on ranges, perhaps 10- to 15-percent ranges at the outset, within which their currencies should remain and countries should adopt policy changes as required to keep their rates there.

I have the impression that notions of that type, the target zone variety, did garner a fair amount of support during last week's congressional summit here in Washington on the exchange rate issue. I was pleased that Deputy Secretary of the Treasury Darman seemed to be interested more than Assistant Secretary Mulford suggested this morning.

I hope the comments of last week reflect accurately the current position of the Treasury. The two bills before the committee seem to promote the goal of monetary reform for the system and that is a second reason why their thrust, I think, deserves support. There is clearly a relationship between the immediate problem of dollar imbalance and the longer run systemic weakness.

In my view, however, one should keep the two fairly separate. I think one should view the effort as a two-step sequential process. First, get the current misalignment corrected as rapidly, as urgently as possible. Second, once you then go to a reasonable alignment among exchange rates, then put in place a new system, be it target zones or something else, which could then start from a reasonable equilibrium and have a chance to succeed.

Those would be the basic themes I would promote and argue before the committee. There is one other important conceptual point that shows up in both bills, which I will take 30 seconds to describe. There are two types of exchange rate difficulty often pointed to by businessmen, the financial markets and the like. One is short run volatility of exchange rates, day-to-day gyrations, and the other is longer run more lasting misalignment of currency values relative to underlying trade positions.

It is important to keep those two separate in your mind. In my view, the volatility problem is not a serious one. There is very little evidence it has much effect on real trade flows, development and the like. What clearly does cause the huge problems of the type we have seen is these lasting misalignments where rates over a long period of time just don't reflect the underlying economics, and therefore cause the type of problems you are talking about.

I think the bills do that, but their language should make sure they do it in any redrafting that occurs. Those would be the objectives of the exercise, as I would see it.

The two bills you have before you, I think, have somewhat different themes. H.R. 3498, which I will call Bradley-Lundine, mandates a set of quantitative requirements for intervention in the currency markets to correct the dollar now, and would create a strategic capital reserve.

You know the details of Bradley-Lundine. I think it raises three major policy questions.

First, can intervention help correct dollar overvaluation? I think the answer to that is unambiguously yes, though it cannot do the whole job.

Economists make a distinction between how much of an exchange rate imbalance is due to the fundamentals—budget deficits, interest rates and the like—and how much is due to pure speculative bubble, meaning psychology that carries the exchange market, like any other market, way beyond what the fundamentals would justify.

In my view, there developed a great deal of speculative bubble, certainly in late 1984 and early 1985, when the dollar rose to these extremely high levels that peaked last February.

Most then would take the view that such a bubble could in fact be burst by counterpsychology, announcement effects like the Group of five in September and direct intervention in the markets, whether sterilized or unsterilized.

I think the effects of European intervention back in February or March, which already began to bring the dollar down from its peak, when it hit 3½ deutsche marks, but also the Group of Five concerted intervention in September, clearly showed that intervention does work.

I don't think there should be too much debate on that at this point. As Congressman LaFalce pointed out, intervention has to lean with the wind. Once the market is moving in the right way, intervention can succeed.

I think to the first point raised by Bradley-Lundine: Can intervention help? The answer clearly is yes.

The second question is whether it works better if sterilized or unsterilized. Most academic analyses conclude that it can work only if unsterilized, because if there is a monetary policy offset, there is no change in the fundamentals.

I would certainly agree that intervention works most effectively instituted in conjunction with more basic policy changes, in particular the need here to get the U.S. budget deficit down. I believe intervention can work against speculative bubbles even if it is sterilized, however, again as demonstrated on two major occasions so far this year.

I think it would be a mistake to legislate sterilized or unsterilized intervention. That judgment should be left to those implementing the intervention policy based on whether they are pricking a speculative bubble, or whether working in conjunction with monetary policy and fiscal policy changes, they are working on a more fundamental underlying problem that requires a broader approach.

Now, the third and most difficult issue raised by Bradley-Lundine is the requirement for certain levels of intervention under circumstances such as the present, where the dollar is substantially overvalued. My bottom line is that it is inherently very difficult to legislate proper amounts of intervention.

I think the bill itself reflects that difficulty by creating such a wide range, $3 billion to $30 billion a quarter under current conditions. But even that wide a range could be a problem.

Suppose the dollar was coming down sharply, which is the diretion you want; should one then sell a further $33 billion in order to push it down further, risking a hard landing?

I would think the wisest course is to require the administration and the Federal Reserve to establish and then meet certain current account and exchange rate targets rather than mandate particular techniques and amounts with which to do so.

Indeed, if we wanted to set up a new system of target zones, that would require the United States and all the other countries to set such targets—and assure international consistency among them.

I would think what you might want to do is require the administration to make proposals as to what the objectives of the United States should be, what exchange rate configuration would be necessary to take it there, and have them report on how they are doing in implementing that strategy and make sure you monitor the policy carefully to make sure it works out.

The second bill before you, the bill sponsored by Congressman Lundine along with Gephardt and Bonker (LGB), takes a broader approach to adjustment, talking about fiscal policy of the United States, and expansionary measures in other countries.

In setting current account and exchange rate targets, legislation should indeed call for the kinds of things cited in that second Lundine bill, such as policy harmonization among the major countries.

I also think it would be desirable to fuse the proposals for fundamental reform in the bills before you, because the more recent Lundine bill calls for consideration of target zones—initially through convening an international monetary conference.

I think the two proposals are complementary on monetary reform and a decision on how best to proceed is tactical. The reporting requirement is essential.

Final point: The major innovation concerning monetary reform is the provision in LGB that new multilateral trade negotiations should not proceed before the convening of a monetary conference, and that no resulting trade agreements be concluded until the administration reports to the Congress on its dollar efforts.

That linkage, I think, is very understandable since the monetary issues are at the root of the current global and U.S. trade imbalance.

Parallel progress between the monetary and trade talks is highly desirable. However, I think there is also an independent need to proceed speedily with new trade negotiations.

A resumption of forward movement toward renewed trade liberalization is an essential element of any strategy to hold back these pressures for new import controls which face this body and the country as a whole.

Moreover, there is an important tactical point. If the United States put into the hopper a new condition now for requiring trade talks to start, that would give a handle to other countries who want to block the trade talks by blocking monetary progress.

I think one might impede and torpedo trade talks by giving others the excuse to do so. Therefore, I would recommend against a legislative linkage of such specificity but prefer a clear sense of Congress resolution that any negotiated trade package would be rejected by the Congress unless adequate monetary changes have been completed in the meanwhile.

What I am suggesting on these monetary issues is something akin to what I heard several of the Members talking about earlier. These are process requirements, but I think they would for the first time bring the Congress into the process of determining international monetary policy.

Set firm targets for the current account of the dollar, based on recommendations from the Secretary of the Treasury and Chairman of the Federal Reserve Board, have separate hearings and require the Secretary and the Fed to have a strategy to reach those objectives as quickly as possible, require a periodic report on their progress in doing so, and make clear that progress on monetary issues should accompany any trade negotiations, with the results of the trade talks ultimately to be considered in light of progress on the monetary front.

Thank you very much.

[The prepared statement of Mr. Bergsten follows:]

CORRECTING THE DOLLAR
AND
REFORMING THE INTERNATIONAL MONETARY SYSTEM

Statement by C. Fred Bergsten

Director

Institute for International Economics

Before the

Subcommittee on International Finance,
Trade and Monetary Policy

House Committee on Banking, Finance
and Urban Affairs

Hearings on H.R. 3498 and H.R. 3573

November 19, 1985

The Problem

The enormous rise of the dollar in the exchange markets from mid-1980 to early 1985 (50 to 80 percent, depending on the weights used and precise base date) has savaged major segments of the American economy, including most of agriculture and manufacturing; destroyed over two million jobs in our tradeable goods sector; caused about three quarters of our current account deficit, which will hit about $125 billion this year; prompted many American firms to shift their own production offshore and contemplate making their new investments abroad rather than at home; generated pressures for trade protection with an intensity not seen since the 1930s; and shifted the United States from being the world's largest creditor country to the world's largest debtor country in just three years. It is clearly a critical national problem in both economic and security terms.

The initiative of the United States and the Group of Five, launched on September 22, is a most welcome if belated recognition of the severity of the problem and the urgency of cooperative action to rectify it. That action has so far succeeded in correcting the dollar by about 7-8 percent, in addition to the market correction of a similar amount which had already occurred since the dollar peaked in late February 1985.

However, the dollar remains overvalued by about 25 percent in terms of the underlying competitive relationship between the United States and other major trading nations.[1] The dollar is only a few percentage points below its average rate for 1984. Without further correction, the US current account will thus continue to deteriorate steadily: to about $150 billion in 1986 and to about $250 billion in 1990, by which time our net foreign debt would approximate $1.1 trillion. Even if one believes that the United States faces international competitive problems going beyond the current exchange-rate imbalance, it would be hard to deny the critical importance of eliminating the price disadvantage caused by these distorted currency relationships.

Hence it is critical to foster a further major currency adjustment, taking the dollar/yen rate to at least 190:1 and the dollar/DM rate to at least 2.2:1. The correction should be achieved in a way which minimizes the risk of a "hard landing,"

1. Updated calculations based on the somewhat different methodologies developed in John Williamson, The Exchange Rate System, Washington: Institute for International Economics, revised June 1985; and in Stephen Marris, Deficits and The Dollar: The World Economy at Risk, Washington: Institute for International Economics, forthcoming December 1985.

with sharp increases in US inflation and interest rates, or overshooting in the downward direction. This is a basic purpose of both H.R. 3498 and H.R. 3573, which deserves strong support.

The present misalignment, however, is only the most recent and most dramatic of a seemingly endemic series of misalignments which has occurred since most major currencies were floated in early 1973. The dollar dropped to unrealistically low levels in 1978-79, taking inflation here into double digits. The yen and DM have experienced opposite patterns, going to overvalued levels in the late 1970s and to substantial undervaluation in the last four years.[2]

Thus, in addition to correcting the present misalignment, there is a need to improve the functioning of the international monetary system in order to avoid the recurrence of large trade imbalances. The most promising technique is to create a regime of "target zones," within which the major countries would agree on ranges of 15-20 percent within which their currencies should remain and adopt policy changes as required to keep them there. H.R. 3498 and H.R. 3573 promote this goal as well, a second reason they deserve support.

The two problems--present imbalance, systemic weakness--are closely related. On the one hand, it might be possible to help achieve the current correction through reforming the system and then applying the new regime to the immediate problem. It is more likely, however, that any new system would falter--and risk being discredited--if it were initiated at a time of substantial distortion among major currencies. Hence I would strongly recommend a two-step sequence: urgent action to complete the present dollar correction as rapidly as possible, followed by a systemic restructuring which would seek to maintain the new equilibrium and avoid severe future misalignments.[3]

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[2] The yen-dollar history is traced in C. Fred Bergsten and William R. Cline, The United States-Japan Economic Problem, Washington: Institute for International Economics, October 1985.

One other conceptual aspect of the problem requires clarification. There are two types of exchange rate difficulty: short-run volatility and fundamental misalignment. Volatility may on occasion disrupt financial markets, but there is little evidence that it has lasting effects on trade and investment decisions. By contrast, as noted above concerning the dollar at present, misalignment--prolonged deviations in the level of rates from underlying equilibrium--can have extensive impact. Hence, both the immediate and systemic reform efforts should focus on correcting and avoiding misalignments, rather than reducing volatility.

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3. Section 4(a)(1) of H.R. 3573 thus seems to put the cart before the horse, though the following subsection (2) addresses both the present and systemic problems; the sequencing should be clarified in any future revisions of the legislation. Section 2(a)(8) also suggests that systemic reform is needed to deal with the immediate imbalances, and should be subsumed in Section (2)(b) which presents the two aspects clearly.

Appraising the Proposals

The two bills under consideration have different themes. H.R. 3498 ("Bradley-Lundine," to recognize the identical S. 1571) mandates a set of quantitative requirements for intervention in the currency markets to correct the dollar now and would create a "strategic capital reserve" to avoid its declining excessively later. H.R. 3573 (Lundine-Gephart-Bonker, or "LGB") places more emphasis on international coordination of national economic policies and systemic reform, including firm linkage between the latter and the launching of a multilateral trade negotiation. I recommend that the Subcommittee modify key parts of each bill and report out a single set of proposals.

Bradley-Lundine requires the monetary authorities to conduct unsterilized intervention in amounts ranging from $12 billion to $125 billion (under current conditions) annually, whenever the US current account deficit exceeds 1-1/2 percent of GNP (about $50 billion at present) and the dollar is overvalued by 15 percent or more. Three major policy questions arise:

-- Can intervention help correct the dollar overvaluation?

-- Should such intervention be unsterilized?

-- Is is sensible to mandate the amount of intervention through legislation?

Events since September 22, indeed since February of this year, demonstrate that skillful intervention can prompt currency correction. The dollar clearly rose faster in late 1984 and early 1985 than could be justified by any reading of "the fundamentals." The resultant speculative bubble could be pricked by a combination of official statements (as on September 22) and intervention, as occurred after the substantial European effort in February-March and the US-led offensive since September 22. The fact that international capital flows are now so large should not discourage the use of intervention; it seeks simply to affect the _balance_ between ex ante supply and ex ante demand for currencies, which is normally quite small as indicated by the self-balancing nature of the markets on most days as recorded in their very modest fluctuations.

To be effective, however, intervention has to "lean with the wind"--supporting the direction of change which is already developing in the market.[4] Since flexible exchange rates became widespread in 1973, most intervention prior to 1985 has leaned _against_ the wind--seeking to limit the day-to-day volatility of "disorderly markets" rather than to correct misalignment of currency levels--and thus sought to buck market trends. Not surprisingly, the "new" approach works much better and demonstrably can succeed. This shift in strategy would be usefully reinforced by the provision in Bradley-Lundine (Section 4(b)) that would _bar_ intervention that leaned against the wind when the wind was blowing in the correct direction from the standpoint of underlying equilibrium.

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[4] As proposed by C. Fred Bergsten, "The Case for Leaning with the Wind," _Financial Times_, October 19, 1984.

Intervention thus can work, expecially if it leans with the wind, but a central issue is whether it works better if sterilized or unsterilized. ("Sterilized" intervention has no net effect on the money supply, as open-market operations are employed to offset its impact; "unsterilized" intervention is permitted to have a full effect on the money supply, e.g., increasing it in the United States when dollars are sold to bring about a lower dollar in the exchange market.) Most academic analyses consider that intervention can work only if it is unsterilized; if the intervention is sterilized, there is thought to be no change in "the fundamentals" and thus no lasting impact on currencies either. This analysis presumably underlies the insistence in Bradley-Lundine on unsterilized intervention.[5]

To be sure, intervention works most effectively when instituted in conjunction with more basic policy changes. Unsterilized intervention amounts to a change in monetary policy, and is thus more likely to succeed.

However, I believe that intervention can work against speculative bubbles even if it is sterilized--as demonstrated both in February-March of this year and since September 22. In the current situation, with the US economy soft and the dollar still considerably overvalued, I strongly advocate a further easing of monetary policy by the Federal Reserve--which could be achieved through unsterilized intervention.[6] I see very little risk of triggering a new rise of inflation through such action, with the inflation numbers so low (zero change in wholesale prices over the last three months, an annual inflation rate under 3 percent) and demand pressures so modest. However, there will be periods in which nonsterilization is neither necessary nor proper, and I would thus oppose making it mandatory.[7]

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[5] Section 5 of H.R. 3498 is in fact not clear on this point, but Senator Bradley stated his intent to require nonsterilization in introducing the bill in the Senate (see S. 10866 of the Congressional Record of August 1, 1985) and his testimony before this Subcommittee on November 14.

The most difficult issue raised by Bradley-Lundine is its requirement for certain levels of intervention under circumstances such as the present, when the US current account is in large deficit and the dollar is substantially overvalued. On the one hand, it is fully understandable that the Congress would wish to require action of this type by the Administration--particularly in a bill originally submitted before September 22--in light of the Administration's previous refusal to intervene seriously even when the need was apparent and all other major countries wished to do so.

However, it is inherently difficult to legislate the proper amounts of intervention. Bradley-Lundine itself reflects this problem, by setting its required levels within an extremely wide range--$12 billion to $125 billion annually under the conditions of 1985, even more in 1986. But even this wide a range could create problems: it might be a mistake to sell $3 billion in a quarter if the dollar were already falling fast, thus risking precipitation of a "hard landing," and sales of $30 billion might be inadequate in some quarters to achieve the needed correction.

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[6] As recommended by Richard N. Cooper, "The US Payments Deficit and the Strong Dollar: Policy Options," paper presented to Federal Reserve Bank of Kansas City Conference, Jackson Hole, Wyoming, August 21, 1985.

[7] The Bradley-Lundine provision to this end also raises the broader question of whether the Congress should legislate monetary policy, which would be the effect of requiring both intervention and nonsterilization.

The wisest course may thus be to require the Administration and the Federal Reserve to establish and then meet certain current account and dollar targets, rather than mandate quantitative use of a particular technique to do so. Indeed, consideration of a new system of target zones would require that the United States (and all other participating countries) set such targets--and assure their international consistency. Bradley-Lundine in fact suggests one set of relevant targets: a current account deficit no larger than 1-1/2 percent of GNP (now about $50 billion) and a dollar overvalued in trade terms by no more than 15 percent. Before proceeding, however, the desired level of each should be discussed carefully--perhaps on the basis of proposals by the Administration, per Section 5(a)(1) of LGB. The Administration could also be required to report to the Congress on its achievement of these targets, as indeed called for in Sections 4(b) and 5(b) of LGB.

LGB takes a broader approach to adjustment by requiring action on fiscal policy by the United States, which lies at the core of the dollar problem, and expansionary measures in Japan and Europe (along with direct intervention). One should not place too much emphasis on "convergence" of economic performance among the major countries, however (Section 4(a)(2)(A)). There has been a great deal of such convergence in recent years, but the international imbalances have grown steadily larger.[8] The need is for closer harmonization of policies, and any new legislation in this area should encourage such efforts. In setting current account and exchange rate targets, as recommended above, any legislation should thus call for policy harmonization along with intervention in listing the instruments to be employed.

It would also be desirable to fuse the proposals for reform of the international monetary system in Bradley-Lundine and LGB. The latter calls for consideration of both target zones and a return to fixed parities, like Bretton Woods or the European Monetary System, initially through the convening of an international monetary conference. Bradley-Lundine would appoint a commission, presumably with members drawn from outside governments, to study the issue and make recommendations on it. The two proposals are complementary, and a decision on how best to proceed is essentially tactical. Again, the reporting requirement (per Section 4(b)) is essential to spur action.

The major innovation concerning monetary reform is the provision in LGB that new multilateral trade negotiations should not proceed before the convening of a monetary conference, and that no resulting trade agreements be concluded until the

[8] C. Fred Bergsten, "Reaganomics: The Problem?" in Foreign Policy, Summer 1985.

Administration reports to the Congress on its dollar efforts. This linkage is understandable, since the monetary issues are at the root of the current US (and global) trade imbalance. Parallel progress between the two sets of negotiations is highly desirable.

However, there is also a need to proceed rapidly with new trade negotiations.[9] A resumption of forward movement toward renewed trade liberalization is an essential element of any successful strategy to resist the powerful protectionist pressures which now face this body. Moreover, other countries might resist, at least for a while, any new US conditions for starting the trade talks--in this case, a linkage to monetary reform. Indeed, those who want to torpedo the trade talks for other reasons would be given a new excuse to do so. So I would recommend against linkage a la LGB, preferring instead a clear sense-of-Congress resolution that any negotiated trade package will ultimately be rejected by the Congress unless adequate monetary changes have been achieved in the meanwhile.

Conclusion

In conclusion, I strongly welcome the efforts in both Bradley-Lundine and LGB to promote a rapid correction of the current dollar problem and lasting reform of the international monetary system. Instead of the rather inflexible provisions now embodied in those bills, however, I recommend:

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[9] The case is spelled out in Gary C. Hufbauer and Jeffrey J. Schott, Trading for Growth: The Next Round of Trade Negotiations, Washington: Institute for International Economics, September 1985.

-- setting firm targets for the US current account and the dollar, based on recommendations to be submitted by the Secretary of the Treasury and Chairman of the Federal Reserve in early 1986 and extensive Congressional hearings;

-- a requirement that the Secretary and Chairman devise and implement a strategy to reach those objectives as rapidly as possible;

-- periodic reports from the Secretary and Chairman on their progress in doing so, taking into account the greater difficulty of achieving international than "purely domestic" targets (as for monetary policy) because of the critical role played by other countries and events outside US control;

-- a clear Congressional statement that progress on both monetary issues should accompany the launching of a new international trade negotiation, with the results of the latter to be ultimately considered in light of progress on the monetary front.

This approach would would take account both of the abrupt change in Administration policy since September 22 and the need to move rapidly into new trade negotiations. But it would also provide, for the first time, a major Congressional initiative to assure American trade competitiveness now and in the future by correcting the exchange rate of the dollar and erecting a reformed system to avoid new misalignments. It would require corrective action by the Administration, against an agreed set of targets, and regular reports to the Congress on implementation. Procedurally, it would adopt an approach on international economic issues somewhat akin to that under which the Federal Reserve now conveys to the Congress its targets for domestic monetary policy and its strategy for meeting those targets. It would therefore promote the trade and economic interests of the United States for the indefinite future, and represent a major step toward avoiding any repetition of the neglect of the past five years which has levied such enormous costs on our society.

Chairman **Neal**. Thank you very much. We would like to hear from Mr. Niskanen.

STATEMENT OF WILLIAM A. NISKANEN, PRESIDENT OF THE CATO INSTITUTE, FORMER MEMBER OF COUNCIL OF ECONOMIC ADVISERS

Mr. **Niskanen**. I have apparently been asked to testify as a representative of theologians. I want to express my sadness about the backsliding of my former colleagues in the administration and about the views expressed in the bills considered and by my colleagues here at the table.

My remarks today first address what I regard as the basic reasons why the dollar has been as strong as it has been and then address the specific bills being considered by the committee.

The strong increase in the value of the dollar, I believe, was primarily due to the change in U.S. fiscal policy relative to that in other countries.

The most important of these changes, I believe, were the business tax provisions of the 1981 tax bill. Even as modified in 1982 and 1984, these changes substantially increased the posttax return on investment in the United States, increasing the demand for investment in the United States.

Another element of fiscal policy which also may have had some effect was the fact Federal spending continued to grow at a very rapid rate and as a consequence the deficit roughly tripled over that period of time.

My own judgment is that the effect of the increase in the demand for investment was substantially larger than the effect of the reduction in the supply of savings, but there is no reason to dismiss the latter effect.

I think the significant decline in the dollar since last February has been a consequence of changes in expectations about future fiscal policy. For the first time in 4 years, the President proposed a serious budget in February, and Congress has taken it seriously—even if they have not approved the specific proposals of the President.

The continuing action by Congress to try to wring out the deficit between now and 1991, I think, has had a similar effect. Also, the administration in May 1985 reversed their tax policy of 1981, proposing changes in taxes that would substantially reduce the posttax return on investment in the United States, and any possible action by Congress on this bill is likely to worsen those business tax incentives, leaving them at a lower level than in 1980.

I attribute both the strong rise in the dollar in the summer of 1980 to the winter of 1985 to a change in fiscal policy and the significant decline in the dollar since February 1985 to a substantial prospective change in fiscal policy.

My interpretation leaves only a minor and temporary role to monetary policy or exchange rate policy in this explanation. In the long run I think monetary policy or exchange rate policy has very little effect on either real interest rates or real exchange rates.

Unexpected changes in monetary policy, however, can have effects, and they appear to have contributed to substantial changes in real interest rates and real exchange rates for short periods. Such periods include the substantial reduction in the growth of the money supply from 1980 through mid-1982 and a similar reduction in mid-1984, both contributing to a strengthening of the dollar.

The G-10 agreement of January 1985 and the G-5 agreement of September 1985, each expressing a greater willingness to intervene against the dollar, appear to have had the opposite effect. Such monetary or exchange rate measures, however, have only a temporary effect on real interest rates and real exchange rates, until the inflation adjusts to the change in monetary policy.

The recent measures were made to defer protectionist pressure in this body until after the next election, but they do not address the conditions affecting the real exchange rate over a longer period. They also risk a substantial increase in the U.S. inflation rate within several years.

This discussion indicates that the dollar may be strong for either good reasons or bad reasons, and it would be inappropriate to look at the dollar as a sufficient guide for policy.

The value of the dollar by itself is not sufficient to determine whether any policy should be changed. It would be a mistake, I believe, to reduce the incentives for business investment, as in the administration or congressional tax proposals, or, for example, to reduce the security of property rights in the United States in the name of weakening the dollar.

It would be correct, I believe, to reduce Federal spending, the deficit, and the tax bias against savings regardless of whether the dollar were weak or strong. Similarly, under different conditions, I believe, it would be a mistake to contract the economy or to restrict imports with the objective of strengthening the dollar.

These several types of policies should be evaluated on their own merits, I think, regardless of whether the dollar is high or low or whether the effects of these policies would strengthen or weaken the dollar.

Let me now turn quickly to the two bills now being considered by the committee. There are a number of technical problems of H.R. 3498 even if one shared its objectives.

It is difficult to estimate the exchange rate that is consistent with the current account balance. Fred's estimate and my estimate, for example, might differ substantially, but it is awkward to write a feature into the law that is dependent upon statistical estimates.

It is also difficult to determine whether the intervention has been unsterilized because this would require an estimate of what policy the Federal Reserve would otherwise have followed, a problem that is difficult under any circumstance.

A much more important problem is that the proposed policy is internally inconsistent. A rapid increase in the U.S. money supply may not reduce the U.S. current account deficit. In fact, it is likely to increase it in the short run, even though it would reduce the nominal exchange rate, because the income effects of this rapid increase in U.S. money supply are likely to overwhelm the price effects on the current account.

In other words, this bill would not accomplish its objective of balancing the current account. The current account can only be reduced by reducing investment in the United States, an undesirable outcome, or by increasing saving, not by manipulating nominal exchange rates.

The most important problem of this bill, however, is that it would lead to a rapid increase in U.S. inflation, a consequence of both the decline in the dollar and the increased money supply associated with the unsterilized intervention. One wonders what possible benefit of this bill would be commensurate with that cost.

The outcomes of approving this bill would be a much higher rate of inflation, no significant change in the current account deficit, a significantly weaker nominal exchange rate, and no particular change in the real exchange rate.

H.R. 3573 addresses somewhat a different issue. It would require the President to convene an international conference of the international monetary system prior to commencing any multilateral negotiations under GATT for a new round of reduction of trade barriers.

For such a conference to be successful, however, there must be three conditions. There must be a shared concern about the current system. We must have at least the outline of a realistic alternative. And we must have an agreement on the basic facts. I suggest that none of these three conditions now exist.

One indication of the confusion on this issue is that most of the so-called findings on which the proposal is based are either incorrect or they reflect a concern in the United States that is not shared by other nations. In such conditions, the major outcomes of an international conference are likely to be boredom and unrealistic expectations.

In this case, moreover, approval of the bill would delay negotiations on a new trade round and the mutual benefits that could result from such negotiations.

For those who are concerned about the current international monetary system, the first obligation is clear thinking about a realistic alternative. Until there is more evidence of such clear thinking, an international conference on this issue would serve no useful purpose, and the proposed deferral of a new trade round would impose costs without any benefit.

Chairman NEAL. Thank you, sir. Does that conclude your statement?

Mr. NISKANEN. Yes, sir.

[The prepared statement of Mr. Niskanen follows:]

WHAT, IF ANYTHING, SHOULD BE DONE ABOUT THE DOLLAR?

By William A. Niskanen, Chairman, The Cato Institute

Mr. Chairman and members of the subcommittee. For several years, the foreign exchange value of the dollar has been the subject of increasing concern. There has also been a developing consensus that something should be done to stabilize the dollar at a lower rate. Both the increasing concern and the developing consensus, I suggest, are misdirected, are focused more on symbol than substance and are equivalent to killing the messenger rather than heeding the message. My testimony today first addresses the broader set of questions about the dollar and then addresses the specific bills now being considered by this subcommittee.

The strong increase in the real foreign exchange value of the dollar from the summer of 1980 to the winter of 1985 I believe, was primarily due to the change in U.S. fiscal policy relative to that in other nations. From 1980 to 1982, the combined effect of the individual and business tax provisions of ERTA and TEFRA increased the post-tax rate of return on investment in the U.S. by about 3.4 percent, increasing the demand for investment. A continued failure to reduce the growth of real federal spending led to a rapid increase in the federal deficit through FY1985, reducing the net supply of saving in the U.S. Over this period, U.S. fiscal policy proved to be incoherent primarily in the sense that it increased the demand for investment in this country and it reduced the supply of saving by this country. The combined effect of these measures increased real interest rates in the U.S., increased the real exchange value of the dollar, and increased the U.S. current account deficit. My own judgement is that the increase in demand for investment was much larger than the reduction in the net supply of saving as confirmed by the strong increase in real investment during this period. Only in this respect does my interpretation of these developments differ strongly from that of my former colleague Martin Feldstein.

Similarly, the substantial decline in the real exchange value of the dollar since February 1985, I believe, was primarily due to a major prospective change in U.S. fiscal policy. The Treasury tax plan released in late November 1984 would have reduced the post-tax rate of return on investment in the U.S. by about 9.6 percent. The President's tax proposal of May 1985 would reduce the post-tax return by about 4.2 percent, but the prospective congressional changes to this proposal are most likely to reduce the return by an even larger amount, reducing the incentives for business investment to a level lower than that in 1980. (The reasons for this prospective reversal of one of the key elements of the initial Reagan program are beyond my comprehension.) In early February 1985, the President's FY1986 budget proposed a major reduction in the growth of federal spending and the level of the deficit. Although federal spending and the deficit in FY1986 are likely to be higher than first proposed, the deficit-reduction process now being considered by Congress has increased the prospect for lower future deficits. The effects of both the tax and spending proposals being considered this year if implemented would reduce real interest rates, the real exchange value of the dollar, and the current account deficit.

My interpretations of these developments assigns only a minor and temporary role to monetary policy or exchange-rate policy. In the long run, monetary policy has very little effect on either real interest rates or real exchange rates. Unexpected changes in monetary policy, however, appear to have contributed to the changes in real interest rates and real exchanage rates in some periods. Such changes include the substantial reduction in the growth of the money supply from 1980 through mid-1982 and a similar reduction in mid-1984, both contributing to a strengthening of the dollar. The G-10 agreement of January 1985 and the G-5 agreement of September 1985, each expressing a greater willingness to intervene against the dollar, appear to have had the opposite effect. Such measures, however, have only a temporary effect on real interest rates and real exchange rates until the inflation rate adjusts to the change in monetary policy. The recent measures may defer protectionist pressure until after the next election, but they do not address the conditions affecting the real exchange rate over a longer period. They also risk a substantial increase in the U.S. inflation rate within several years.

This discussion indicates that the dollar may be strong for either good or bad reasons. The value of the dollar, by itself, is not sufficient to determine whether any policy should be changed. It would be a mistake to reduce the incentives for business investment or to reduce the security of property rights in the U.S. in order to weaken the dollar. It would be correct to reduce federal spending, the deficit, and the tax bias against saving, regardless of the level of the dollar. Similarly, under different conditions, it would also be a mistake to contract the economy or to restrict imports with the objective of strengthening the dollar. These several types of policies should be evaluated on their own merits, regardless of the level of the dollar or their effects on the dollar. What, if anything, should be done about the strong dollar? Nothing!

Political and monetary authorities have occasionally expressed the view that real exchange rates can be changed by foreign exchange intervention, without changing the primary conditions that affect these rates. Two types of interventions should be distinguished. "Sterilized" intervention involves the purchase or sale of national currencies with an offsetting action in domestic financial markets. Such intervention can contribute to exchange rate stability only if the central banks, using other people's money, are more effective currency speculators than are private speculators using their own money. Moreover, these two groups should be judged by the same standard--whether they have made money, on net, on these transactions. By this standard, neither central banks nor most private speculators in the exchange markets have a very impressive record. On the other hand, sterilized intervention is one central banker's game that does not have serious adverse effects on the economy.

"Unsterilized" intervention, in contrast, involves the purchase or sale of currencies without an offsetting action in domestic markets. An unsterilized purchase of a foreign currency, for example, increases the domestic monetary base and has much the same effect as on open-market purchase of government securities. Such intervention subordinates domestic monetary policy to achieving or maintaining some desired exchange rate and can have very adverse effects. An increase in the demand for domestic investment, for example, would lead to a procyclical increase in the money supply. Similarly, a general increase in the demand for foreign investment would lead to a contraction of the money supply. It is most important to recognize that the monetary authorities cannot stabilize both specific prices, such as interest rates and exchange rates, and real conditions, such as output and employment. Any attempt, specifically, to stabilize exchange rates is likely to lead to increased instability of real conditions, at best, a Faustian bargain.

The joint statement on September 22 by the Group of 5, as with most such statements, is difficult to interpret. In addition to the usual rhetoric about seeking a "convergence" of economic policies, there was one critical paragraph:

> "5. Ministers and Governors were of the view that recent shifts in fundamental economic conditions among their countries, together with policy commitments for the future (my emphasis), have not been reflected fully in exchange markets."

The prospect that Ministers and Governors understand the "fundamental economic conditions" better than market participants is most unlikely. The emphasized phrase, however, implies an agreement on a coordinated change in policy. The most plausible interpretation of this agreement is that the several nations agreed to intervene, on an unsterilized basis if necessary, to weaken the dollar and strengthen the yen. The direct effect of this policy change, a substantial decine in the dollar/yen rate, has already been realized. This policy is also likely to increase U.S. economic growth in the near-term and

U.S. inflation within several years; the effects in Japan would be just the opposite. A possible outcome may be to increase the U.S. trade deficit with Japan, even at a lower dollar/yen rate. If this interpretation is correct, the U.S. appears to have subordinated any near-term concern about inflation to achieving a lower dollar exchange rate. The Reagan administration has yet to explain that two of their major economic policy initiatives of 1985, the tax proposal and the change in monetary policy, have reversed two key elements of their 1981 program.

The two bills now being considered by this subcommittee, unfortunately, also subordinate more important concerns to the foreign exchange value of the dollar. H.R.3498 would require the purchase of at least $3 billion of foreign currency during any quarter for which the current account deficit has exceeded 1 1/2 percent of GNP during the prior four quarters and the trade-weighted exchange rate is more than 15 percent above a rate that would lead to a current account balance. Moreover, the required intervention is intended to be unsterilized. There are a number of technical problems of this bill, even if one shared its objectives. It is difficult to estimate the exchange rate that is consistent with a current account balance. It is difficult to determine whether the intervention has been unsterilized, because this would require an estimate of what policy the Federal Reserve would otherwise have followed. A more important problem is that the proposed policy is internally inconsistent; a rapid increase in the U.S. money supply may not reduce the current account deficit, even though it would reduce the nominal exchange rate, because the income effects may overwhelm the price effects on the current account. In other words, this bill would not accomplish its objective. The current account deficit can only be reduced by reducing investment in the U.S. or by increasing saving, not by manipulating nominal exchange rates. The most important problem of this bill, however, is that it would lead a rapid increase in U.S. inflation, a consequence of both the increased money supply and the decline in the dollar. One wonders what possible benefit of this bill would be commensurate with this cost.

H.R.3573 would require the President to convene an international conference on the international monetary system, prior to commencing any multilateral negotiations under the General Agreement of Tariffs and Trade for a new round of reductions of trade barriers. For such a conference to be successful, however, there must be a shared concern about the current system, the outline of a realistic alternative, and an agreement on the basic facts. These conditions do not now exist. One indication of the confusion on this issue is that most of the "findings" on which this proposal is based are incorrect or reflect a concern that is not shared by other nations. In such conditions, the major costs of an international conference are usually boredom and unrealistic expectations. In this case, moreover, approval of the bill would delay negotiations on a new trade round and the mutual benefits that could result from these negotiations. For those who are concerned about the current international monetary system, the first obligation is clear thinking about a realistic alternative. Until there is more evidence of such clear thinking, an international conference on this issue would serve no useful purpose. And the proposed deferral of a new trade round would impose costs without any benefit.

Chairman NEAL. Mr. Fox.

STATEMENT OF LAWRENCE A. FOX, VICE PRESIDENT, INTERNATIONAL ECONOMIC AFFAIRS, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. FOX. Thank you, Mr. Chairman.

I don't think there is any sector of the American economy that has suffered from the high dollar to the extent that the manufacturing sector has, and the employees of the manufacturing sector.

When the high dollar is removed and you have some kind of equilibrium rate, many of the consquences of that prolonged period, now 5 years, will continue for an indefinite period, as plants once located in Cleveland, for example, no longer exist in Cleveland and will not be brought back.

There isn't time for debate on a theological plane or on the basis of what might have been. I am suggesting that there is some urgency, a great deal of urgency, in getting at this problem.

I think the two bills before the committee are laudable attempts in that direction. Unfortunately, I can't agree with the methods chosen in either one.

Might I just summarize my points quickly? I know that the hour is late.

NAM is encouraged by the results of the G–5 meeting on September 22. We think the results of that meeting are evident in the exchange markets. It is only 2 months since that meeting. We don't know really how fundamental the changes are likely to be if that progress is not sustained, nor how fundamental the results will be if the progress is sustained as we hope.

We know one thing quite certainly: There is certainly no change as yet in the trade balance. Second, while encouraged by the G–5 process, we are disturbed by the Treasury's explanation of G–5 and how it is a continuation of a process announced at Williamsburg 3 years previous, and we are impressed by Mr. Levin's comments on the inconsistency of argumentation in the Treasury's support of G–5.

Our conclusion is not to put the Congress in charge of day-to-day monetary policy and exchange rate policy, but for the Congress carefully to monitor the results of G–5 in all its aspects and draw some conclusions.

In this respect, I would like to quote Bob Rosa, who says the process of intervention is one in which we will learn something about curency intervention under current conditions. We will learn which techniques are more effective in achieving exchange rate results, which techniques are costly and which are less costly, and which results are more lasting. I am very much of that point of view.

Third, the question of macroeconomic policy. G–5 did have a macroeconomic content of great importance with strong emphasis on Europe and Japan growing on a more sustained basis and reduction in the United States budget deficit.

If neither of those conditions, the faster growth abroad nor prompt reduction in the U.S. budget deficit takes place, we will hear lots of talk from many experts and nonexperts that G–5 didn't work, intervention was hopeless, and we told you so, and we will have lost an important opportunity to move forward in the area that clearly requires action.

My own view is that floating was always part of the problem. It was an imperfect system, appeared suitable to the circumstances for awhile, in the early and mid-1970's, particularly in relation to the oil prices, but then, to coin a phrase, showed its true feet of clay.

I think we have to move on, that is my fourth point. We have to get on with the subject of international monetary reform using our experience in G-5 as the basis for experience and conclusions for that reform.

But I would not say that that reform should take place in a helter-skelter manner; certainly the GATT negotiations should not be precluded from taking place until an international monetary conference is convened and concludes its result.

I think, as you know, I strongly favor the proposed GATT trade negotiations. I also strongly favor beginning what I call parallel negotiations on the monetary side. I would call a formal monetary conference, however, until we have learned and evaluated more of the experience under G-5.

Therefore, NAM is strongly sympathetic of the efforts of the Congress and gives great credit to the Congress in pushing the Treasury in the direction that it has gone, but we do not favor a mechanistic approach to the building up and use of foreign exchange reserves.

We note, of course, that in addition to the exchange equalization fund, the Federal open market committee has authority and has authorized higher foreign exchange reserves. Just last month the FOMC authorized an increase in those reserves from $5 to $10 billion. That does not require an authorization of Congress. The Fed has that authority. The Fed reports on its use of that authority, and I think the Fed and the Treasury both should be reporting to the Congress periodically on the progress achieved.

I would like to conclude on sort of a somber note.

A cautionary note.

Although progress has been made in reducing the exchange rate for the dollar, more is needed.

Results in the U.S. trade balance are so far not there and are still far off. Foreign producers will fight to maintain newly won shares in the U.S. market as well as in foreign markets.

The results of macroeconomic coordination, so-called convergence, so far are more theoretical than real. It remains to be seen what additional growth in Europe and Japan will take place and whether increased United States exports will result.

The vital element of a major reduction in the U.S. budget deficit is still before us and whether that major reduction of the budget will take place soon enough to help the G-5 process or to help the spread of it, we don't know. In any event, we have to be thinking about an improvement in the exchange rate system and we have to prepare for it.

I did attend the monetary conference held a few days ago by the congressional leaders. I think there was widespread dissatisfaction with the current version of floating.

I think, also, there was a strong support of Eddie Bernstein's statement when he said it took 30 months to prepare for Bretton Woods. Well, I think we better take some time to prepare adequately for the next monetary conference and we have a very good forum in the G-5 from which to learn.

Let me conclude by saying we cannot count on exchange rates that do the whole trade job. There is a task requiring a national priority for a sustained trade strategy.

This is not one that vibrates from day-to-day on politics that turn on the problems of a particular industry, or a determination as to what is at that moment called protectionism, neoprotectionsm or mercantilism. I think we need a trade strategy addressed to the interests of the United States as a part of a world economy that certainly means one that emphasizes export potential and makes domestic prices realistic with respect to foreign goods entering our market.

My cautionary word is I think "unnecessary" before this group which is so well aware of the industrial implications of the exchange rate, but I note in some quarters excessive euphoria over G-5, and I just felt that one should understand so far it is only in the exchange markets, it is not in the trade area that we see results.

Thank you.

[The prepared statement of Mr. Fox follows:]

TESTIMONY OF

LAWRENCE A. FOX
VICE PRESIDENT, INTERNATIONAL ECONOMIC AFFAIRS
NATIONAL ASSOCIATION OF MANUFACTURERS
ON

H.R. 3498 AND H.R. 3573

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON INTERNATIONAL FINANCE, TRADE
AND MONETARY POLICY
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NOVEMBER 19, 1985

Mr. Chairman, Members of the Committee, I am Lawrence A. Fox, Vice President for International Economic Affairs of the National Association of Manufacturers. NAM is the nation's oldest national trade association, with membership of more than 13,000 companies, ranging from the smallest to the largest companies in the United States. Together they account for approximately 80 percent of U.S. industrial output and more than 85 percent of U.S. industrial employment.

Today I want to focus on the issues raised by two pieces of legislation before this committee, H.R. 3498 and H.R. 3573. Both of these bills deal with the problems created for U.S. trade and investment by the fact that,at least through the early part of this year, the exchange value of the dollar continued to rise for almost five years despite worsening deficits in both our trade balance and the balance of payments on current account. The main points I would like to make today can be summarized as follows:

1. NAM is encouraged by the G-5 announcement of September 22 and the coordinated actions in exchange markets undertaken by the U.S. government and those of the other major industrial countries. We believe that this action has in large part been prompted by the urgings of Congress, as well as American industry, and agriculture. We note with approval that the G-5 agreement also calls for certain macro-economic steps by the U.S. and the other participants.

2. While encouraged by the G-5 announcement, we also recognize that no exchange rate policy or trade program will be successful if undermined by the current imbalance in U.S. macro-economic policies caused by our huge federal budget deficits. Credible action to reduce the budget deficit by Congress and the Administration is essential.

3. There is little doubt that in the future the U.S. will require greater reserves of major foreign currencies to participate in the new efforts involving coordinated exchange intervention. We see this need to be met by normal Federal Reserve -Treasury action, rather than by creation of special "strategic" reserves in a fashion dictated arbitrarily by Congress.

4. Longer-term reform of the exchange rate system is necessary. However, it is premature to specify exactly what changes need to be made. Our ideas on future reform should be derived from the G-5 experience of coordinated intervention and the attendant efforts of macro-economic policy convergence among the participating countries.

5. NAM is strongly sympathetic to the objectives if not the methods chosen in H.R. 3498 and H.R. 3573. We believe both bills contain some deficiencies. H.R. 3573 would require that the President convene an international monetary conference before the next round of GATT negotiations. We believe that

> an international monetary conference should parallel GATT discussions, but question whether the President should be legally prohibited from entering into the GATT negotiations until an international monetary conference is convened. H.R. 3498 establishes a legal requirement for U.S. currency market intervention that is too rigid and mechanistic. Since the Treasury Department has now accepted the need for coordinated intervention to reduce the value of the dollar and has acted accordingly, we believe that the progress of this policy should be closely studied before any more direct action is taken through legislation. In any case, acquisition of foreign exchange reserves can be undertaken by the Federal Reserve without additional specific instruction or authorization by the Congress.

Before elaborating on these points, I would note that NAM recently published a booklet detailing the relationships between the high dollar, the decline in U.S. industrial competitiveness, the trade deficit and the faltering of domestic economic growth since mid-1984. Copies have been provided to all members of Congress, but additional copies of this booklet are being provided to the subcommittee at this time. In addition, an annex to this testimony is submitted for the record which illustrates further how the dollar exchange rate has contributed to the trade deficit, and updates our booklet with later 1985 data. I would ask that this annex be added to the record of this hearing as part of my testimony.

The focus of my testimony this morning will not be the facts of the trade deficit and the exchange rate problem, which are now well known, but rather the policy issues raised by the proposed legislation.

Implementation of G-5 Announcement of September 22

NAM is strongly encouraged by the G-5 announcement of September 22 and the coordinated actions in exchange markets undertaken by the U.S. government and those of the other major industrial countries. Coordinated intervention in exchange markets for the explicit purpose of moderating the dollar's value represents a significant change of policy by the U.S. Treausry Department and the Federal Reserve. It signifies that the exchange rate of the dollar is now an explicit objective of U.S. economic policy. This action has led to an 8 percent decline in the overall dollar exchange rate and a 15 percent fall in the dollar's exchange value against the yen since the date of the G-5 announcement, September 22. The decline of the dollar relative to the D-mark is 9 percent.

The persistence of many members of Congress -- representing both political parties -- in identifying the misaligned dollar exchange rate as a key casual factor in the U.S. trade problem has had a beneficial effect on U.S. policy. It is my view that the G-5 announcement of September 22 represented a major change of policy by the Treasury Department regarding the role that the U.S. government must play in exchange markets if the dollar is to reflect the relative competitive position of U.S. industry, and if this Administration is to have a credible trade policy that avoids giving encouragement to protectionist-type "solutions" to the U.S. trade deficit. The leadership of NAM and executives representing member companies met with Secretary Baker on July 16 to urge the action that now has been taken by the G-5 countries.

It is only two months since the G-5 announcement. It is too early to draw final conclusions from this limited experience. But there are three points I would like to make regarding these bills.

1. Coordinated intervention by G-5 has significantly reduced the exchange value of the dollar. The trade effects, if any, are still to be seen in the future.
2. Long term reform of the exchange rate system is necessary.

Last week I participated in a major bi-partisan conference on global monetary reform convened at the initiative of members of Congress, including Congressman Kemp and Senator Bradley, (who introduced the original Senate version of H.R. 3498). The conclusion of virtually all of the experts who attended the meeting is that the exchange rate system needs reform and that continued coordinated action by G-5 in exchange rates and macro-economic policy is useful and necessary.

3. It is premature to prescribe specific changes in either the structure of the exchange rate system or how the U.S. government should implement exchange rate policy. It is reasonably clear, however, that a more stable exchange rate system must be introduced, one that falls somewhere between a fixed rate system and the old version of floating. It is evident, also, that greater attention by the U.S. Government to exchange rate policy is necessary, and the ability to intervene in exchange markets is needed.

In the short period since September 22, coordinated intervention has rolled back nearly one-quarter of the dollar's nominal appreciation on the Fed index since 1980. But the index is still 47 percent higher than its average 1980 value. What we will learn in the G-5 process of this active coordination of exchange rate policy, as well as efforts to coordinate macro-economic policies on an international basis, will help to demonstrate what should be the substance of international monetary reform.

Comments on H.R. 3498 and H.R. 3573

NAM is sympathetic to the objectives but not the methods chosen in H.R. 3498 and H.R. 3573. We believe both bills contain deficiencies. H.R. 3573 would require that the President convene an international monetary conference before the next round of GATT negotiations. We believe that an international monetary conference should parallel GATT discussions, but question whether the President should be legally prohibited from entering into the GATT negotiations until an international monetary conference is convened. H.R. 3498 establishes a legal requirement for U.S. currency market intervention that is too rigid and mechanistic. Since the Treasury Department has now accepted the need for coordinated intervention to reduce the value of the dollar and has acted accordingly, we believe that the progress of this policy should be closely studied before more direct action is taken through legislation. In any case, acquisition of foreign exchange reserves can be undertaken by the Federal Reserve without additional specific instruction or authorization by the Congress.

Conclusion

I must conclude on a cautionary note.

Progress has been made in reducing the exchange rate for the dollar, and more is needed. Results in the U.S. trade balance are still far off. Foreign producers will fight to maintain newly won shares in the U.S. market, as well as in foreign markets.

The results of macro-economic coordination are so far more theoretical than real. It remains to be seen what additional growth in Europe and Japan will take place, and whether increased U.S. exports result.

The vital element of major reduction in the U.S. budget deficit also must take place sufficiently soon to help the G-5 process; lack of progress will tend to discredit the G-5 approach, and efforts at reform of the exchange rate system.

Finally, let us not count on exchange rate changes to do the whole job of improving U.S. trade performance. That is a task requiring a national priority for a sustained trade strategy.

Annex to Testimomy of Lawrence A. Fox

The Exchange Rate and the Size of the Trade Deficit

While the role of the high dollar in contributing to the growth of the trade deficit is now widely conceded, reviewing the development of this problem can give us some policy direction or guidance for the future. Instead of acting like a self-correcting automatic pilot--as was explicitly anticipated when the floating exchange rate regime came into existence--the dollar exchange rate has behaved perversely with respect to U.S. trade. It has pushed our country ever farther off the course indicated by our trade and current account deficits, making these deficits even worse.

This situation is clearly illustrated in Chart 1, which measures our manufactured goods and total trade balances against the Federal Reserve's 10-country index of the dollar exchange rate. From 1975 to 1980 the relationship between exchange rates and the trade deficit was roughly as predicted under the floating rate regime. The dollar peaked in 1976 at an average value of 5.6 percent over the 1973 pre-float value. This contributed to a subsequent elimination of surpluses in both total and manufactured goods trade balance. The latter, which excludes oil import fluctuations, fell sharply for two years after this period of a relatively strong dollar, reaching a then-record annual deficit of $12 billion (imports c.i.f.) in 1978. The dollar subsequently fell, undermined by a weakening U.S. trade balance. The lagged effect of the "cheap" dollar, which averaged about 10 percent below nominal 1973 parity from 1978 through 1980, clearly contributed to a recovery of the manufactures trade balance to a surplus of over $12 billion by the latter year.

After 1980 we see a sharp discontinuity in this relationship. The dollar rose steadily and steeply through the end of last year against the Fed index. It did not reverse this climb as the U.S. trade deficit worsened from late-1970s levels and the manufactures balance slid back into the red. Thus, in 1984 the dollar averaged about 60 percent higher than its 1980 level, and nearly 40 percent higher than the March 1973 level that is the base for the Fed index. Meanwhile, the overall trade deficit worsened to $123 billion last year and the manufactures deficit to about $88 billion. The overall decline in the dollar's value thus far in 1985 has not yet apparently had much of an impact on the growing trade deficit. Through nine months, the annual rate of the overall trade deficit is over $140 billion and the manufactures deficit is $110 billion.

How much of this deficit is due to the exchange rate alone? International economic factors may be so closely interrelated that it is difficult to assign specific weights to individual causes of a rise or fall in the trade deficit. For example, some analysts emphasize the loss of Latin America export markets due to the debt crisis and others point to the negative U.S. trade effects of relatively slower growth in Europe. But both of these problems relate back to the impact of a high dollar and higher U.S. interest rates on world growth in general. To cite one estimate, Dr. Jeffery A. Frankel, currently with the University of California at Berkeley and until recently a member of the staff of the Council of Economic Advisers testified on November 7:

> "There can be no doubt that the tremendous appreciation of the dollar between 1980 and the beginning of 1985 explains more than two-thirds of the $100 billion deterioration in the U.S. trade balance over that period. The dollar and its lagged effects explain virtually all of the continued $20 billion deterioration of the trade balance this year."

Chart 2 indicates how this determination of the trade balance has influenced the overall current account. At first glance we can see how the dramatic decline in the U.S. trade balance has pulled down the overall current account, despite surpluses in earnings in services and investment income. But as late as 1981, we had a small current account surplus despite a substantial trade deficit. As the U.S. has moved toward "net debtor" status--and particularly as the U.S. Government has helped to finance its federal budget deficit by importing foreign capital--the favorable gap between our trade deficit and the current account deficit has disappeared. In the first half of 1985, the annual rate of the overall current account deficit at $124 billion was the same as the annual rate of the trade deficit on a balance of payments basis, i.e. government borrowing and interest on foreign indebtedness have wiped out private sector earnings abroad.

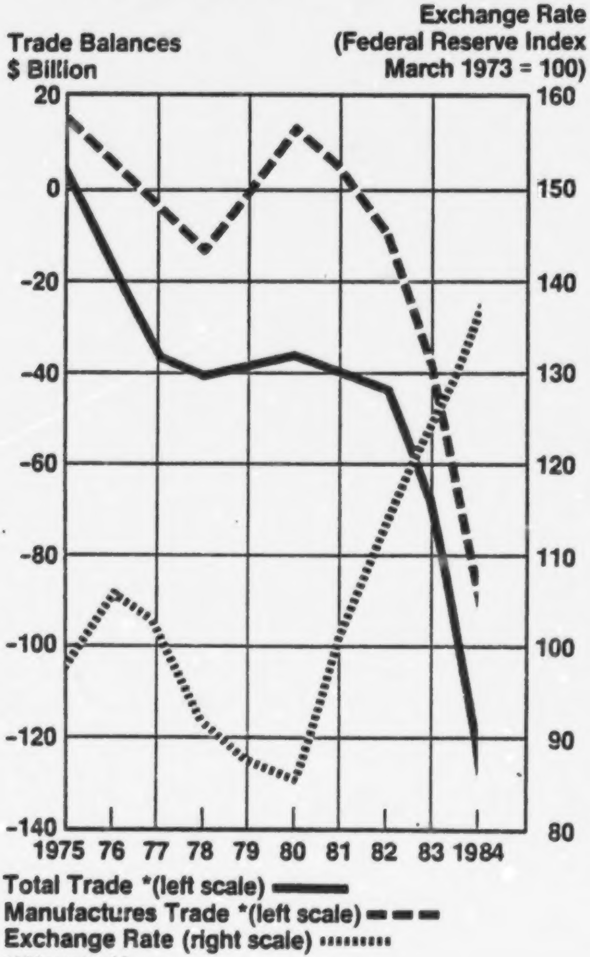
Yen-Dollar Relationship and U.S. Trade Deficit with Japan

There is another issue here that has been frequently raised, and that is the dollar-yen rate. Although Japan accounts for about one-third of our total trade deficit this year, it has been pointed out that unlike most European currencies, the yen actually tended to strengthen in 1982-85 or at least not to fall against the dollar. This comparison is misleading because it ignores superior performance by Japan in growth, productivity and control of inflation, as well as Japan's rapid increase in its current account surplus. These factors should have lead to a much greater appreciation of the yen than actually occurred.

Calculation of the "real" effective exchange rate requires statistical adjustment in the nominal market exchange rates to account for these differences in economic performance. According to the widely used Morgan Guaranty real effective exchange rate index the yen as late as August of this year was 6.3 percent below its average real value in 1980-82. This is even lower than the DM, which was 4.5 percent lower than the 1980-82 average. The dollar, despite having fallen since February, was 17.8 percent higher than the 1980-82 base level. In the case of both Germany and Japan, the gap between their real effective exchange rate and the U.S. rate was substantially higher in mid-1985 than in 1982. In other words, the yen and the mark should have appreciated, not depreciated vis-a-vis the dollar.

Since the "real" exchange rate measures the penalty paid or advantage gained by national manufacturers on world markets due to nominal exchange rate shifts, it is not surprising that Japan has increased its general trade surplus as well as its bilateral surplus with the United States, despite a nominal stabilizing or even strengthening of the yen. Chart 3 compares the U. S., Japanese and German manufactured goods trade balances. While the U.S. manufactured goods trade deficit hit an annual rate of $107 billion in the first half of 1985, the Japanese now maintain a surplus in manufactured goods of over $120 billion and the Germans, despite slow growth of demand in their prime markets in Europe, have a global manufactures surplus of over $60 billion.

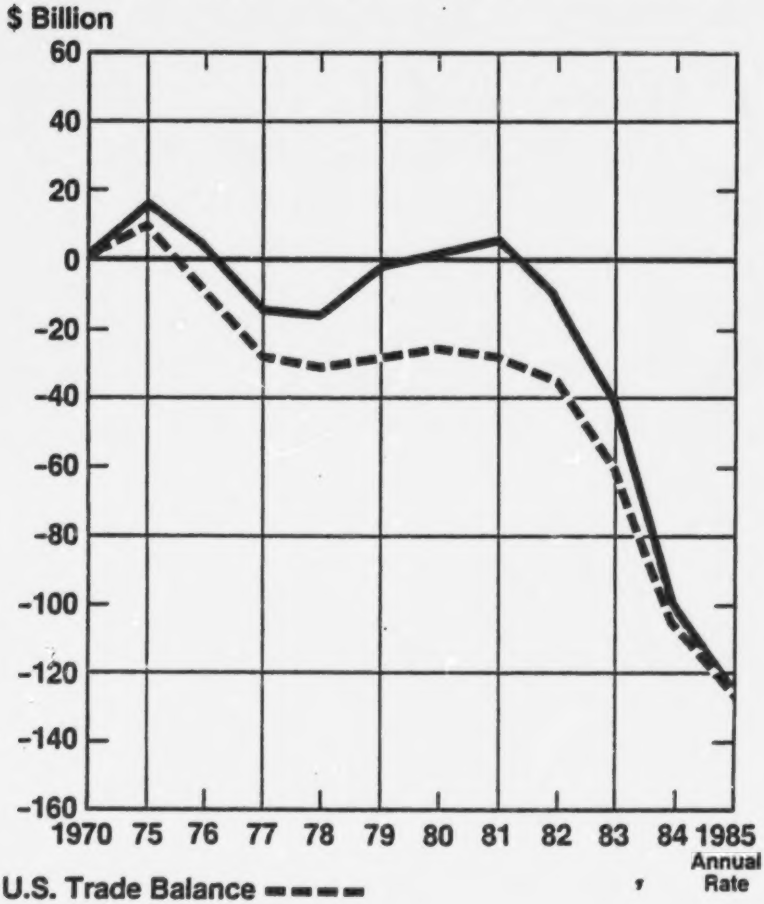
Chart 1:
U.S. Trade Balances and the U.S. Dollar Exchange Rate, 1975–1984



*All imports c.i.f.

Source: NAM, from Commerce Department, *International Economic Indicators*; *1985 Annual Report* of the Council of Economic Advisers.

Chart 2:
U.S. Trade Balance and U.S. Balance of Payments on Current Account



U.S. Trade Balance - - - -

U.S. Current Account ——
Balance of Payments Basis

Source: NAM

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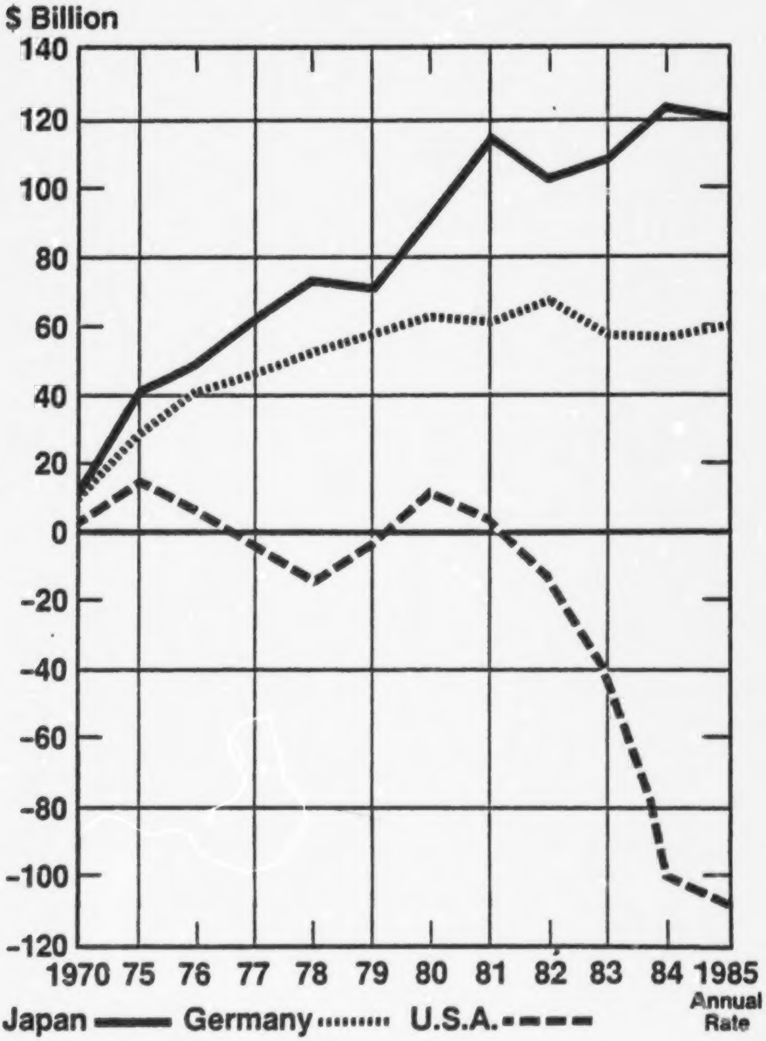
Chart 3:
Trade Balances in Manufactured Goods



Source: NAM, from Commerce Department data.

Chairman **Neal**. Thank you.

Mr. Fox, if I may ask a couple brief questions.

If I understood your comments correctly you want to see intervention but you don't like that that is spelled out in this bill?

Mr. **Fox**. I don't believe the Congress should dictate to the Treasury and the Fed when and how to acquire foreign exchange reserves, and when to intervene and in what manner.

I think the emphasis——

Chairman **Neal**. But you do want intervention, do I hear you correctly?

Mr. **Fox**. I think we should be prepared to implement an exchange rate policy. In my more complete statement I refer with satisfaction that the United States now seems to have three elements of macroeconomic policy, the exchange rate in addition to monetary and budget policy.

I think a country in our situation that is so much interrelated with the rest of the world in trade in goods and services has to keep its eye on the exchange rate, and be prepared to do what is necessary.

A degree of currency intervention obviously is needed if that objective is to be met.

Chairman **Neal**. One other question—well, you would leave that up to——

Mr. **Fox**. Leave it up to the Treasury and the Federal Reserve, subject to Congress requiring those two organizations to explain what they are doing. Actually the Treasury went on for 4½ years without ever telling us what their real policy was other than as Mr. Levin has said, trust us and by the way, the dollar won't remain high forever. Well, it remained high for a much longer period than had been anticipated with tremendous harm to U.S. manufacturing and farm interests, as well as mining interests.

I don't think we have another 5 years to wait for the normal processes to take place. I am not suggesting that that is likely, but I do feel that Congress has an important policy responsibility in this area, but I don't think it ought to be in day-to-day exchange operations.

Mr. **Bergsten**. Could I add one sentence, Mr. Chairman, on what Larry said.

Chairman **Neal**. Yes, sir.

Mr. **Bergsten**. I think in a sense it is worse than he said. It is important to point out that the administration didn't have an exchange policy. Mr. Niskanen said they had one. But it was firm, unrelenting opposition to any intervention in the exchange markets. It was clear. I happen to think it was clearly wrong and that Congress should have had some input.

But I think Larry's bottom line is correct. There was no meaningful congressional input. Therefore, the problem accumulated to the point where we have the massive trade problem we have today.

Chairman **Neal**. I think I would have to say the fiscal policy was clear and announced. It was to double the national debt. What could be clearer?

Let me just ask one other quick question if I can?

Mr. Fox, you say you want to replace the floating exchange rate. What do you want to replace it with?

Mr. Fox. Well, I am not entirely sure. I am very sympathetic to the work Fred Bergsten and John Williamson have done at their institute. I think there is a lot of merit in the target zone system and it ought to be watched very carefully.

There is much more discipline possibly through the target zone system than commonly realized, particularly if one understands the description as to the role of the buffers. The buffers are just outside the 10 percent on either side of the reference point.

When the exchange rate pierces or enters the buffer zone, something is triggered which could very well be first, review of the budget policy in the country concerned or second, review of how the convergence strategy has been implemented, or third, to consider a current question as to why the German's continue to love such a cheap mark, which would be a relevant consideration.

So it is not an automatic pilot system at all. Of the proposals out there, frankly I think the target zone system is the most advanced in terms of thinking, it has the support of several foreign countries, and it can be a flexible system. It is not a return to fixed rates. It is a return to—it is an introduction of an ordered kind of flexibility. I think it would be well worth consideration by this committee in some greater detail with respect to its merits and possible difficulties for longer range reform of the international exchange rate system.

Chairman Neal. Mr. Niskanen.

Mr. Niskanen. The committee should recognize that the United States faces an opportunity to have either an exchange rate policy or monetary policy, but it cannot have both.

If you want the Fed to conduct monetary policy to maintain exchange rates on a fixed basis or within a band, you have to allow the Fed to subordinate any other concerns about the state of the economy to maintaining that band.

Now, that is the central issue. Do you want to give guidance to the Fed so that they conduct their policy with this one objective, maintaining the exchange rates within a certain band—even the gold standard had a small band—or do you want to give them guidance that their policy should be based upon conditions that I think are of much more interest and concern to the general economy.

You cannot have it both ways.

That is the issue which is at stake.

I have long supported greater congressional guidance to the Fed. The only thing that has tempered my enthusiasm for that are the ideas that Congress comes up with on occasion. The primary problem is that the Congress often sets either infeasible targets for the Fed or it sets targets that I think do not reflect the real balance of interests in and among Members of Congress.

If we had monetary policy geared to maintaining an exchange rate band, our monetary policy then would be driven by conditions other than what we may be concerned about. For example, if we had, as a consequence of a change in the tax law an increase in the demand for investment in the United States, the monetary policy that would be triggered would be to increase the money supply in order to maintain the exchange rate band. In that case, it would be procyclical, it would be feeding the investment boom with an increase in money supply.

Conversely, if for whatever reason there was increase in the demand for investment abroad, it would require contracting money growth, contracting the domestic economy in order to maintain the exchange rates.

Also you would be subordinating monetary policy to whatever conditions existed in other countries. If other countries were feeding their money growth in order to maintain an exchange rate, we would have to feed our money growth. I see no reason whatsoever why it is valuable to us to maintain higher money growth to maintain the exchange rates within a certain band because other nations are inflating.

Flexible exchange rates introduce an uncertainty into the system that is not the case with fixed exchange rates, but there are different uncertainties. We really have the choice of which uncertainties we most prefer to live with, uncertainties in the exchange rate over a period of time, or greater variability in real economic conditions in the United States.

I suggest that it would be a mistake to subordinate domestic monetary policy to what I regard as a rather artificial objective of maintaining exchange rates within a more narrow band.

Chairman NEAL. Mr. Bergsten.

Mr. BERGSTEN. Just an important footnote to what Bill just said. I think as a long run, steady state proposition, his statement is accurate on the relationship of monetary policy and exchange rate policy. I do think, however, there are some conditions, and they are very important ones in the real world, where you can have both.

That is the case I referred to in my statement where there is a speculative bubble that carries the exchange rate way beyond where the underlying fundamentals, including monetary policy, would take it to. Then you get an asset-price readjustment with sterilized intervention, thereby not disrupting monetary policy, but creating some exchange rate adjustment.

Now, you cannot get that all the time. It only occurs when you have the psychological bandwagon effects. But I think the events of the last year are in fact one such occasion and so I think there has been over this last 8 months an almost prototypical soft landing for the dollar.

It came back 15 percent from its peak, with still a long way to go, but that occurred with inflation continuing to decline, interest rates staying down, and at this point I don't see any sign in the exchange market action that will turn that around.

Mr. NISKANEN. I will acknowledge that there may be occasions in which Government officials playing with other people's money, are wiser about recognizing speculative bubbles than private operators. But I think it is unlikely.

The track record over a period of time is really rather bleak as to whether Government officials have recognized when the market is inconsistent with fundamental economic conditions.

The test of that is whether the Fed has made money speculating in the exchange market. That has not been the case. On net they have lost a little money. Every once in a while they hit it lucky as has been the case this year. But the record over a longer period is that the Fed has no specialized information on which to speculate in the exchange markets that would lead it to more efficient and smoother exchange rate fluctuations than the private participants in that market.

The Fed may have specialized information about a change in policy and that was the phrase in the G-5 agreement, but then we should address whether the change in policy is appropriate.

We have had M1 growth of something over 10 percent a year now for 3 years in a row, and it looks as if the greater willingness to intervene is likely to lend to higher M1 growth than the rates in the last several years.

I don't know of any period in American history or in the history of other industrial countries, in which you can run money growth that high over a sustained period of time, without inflation increasing at least to the rate of the money growth.

In addition, if the instrument by which the money growth is achieved is by devaluing the dollar—in other words by buying foreign currencies—you are going to have a double whammy on inflation as a consequence of both the money growth and the higher price of foreign goods.

That is already happening. We have one report on the producer's price index for last month that had the index going up nine-tenths of 1 percent in 1 month. Now as a rule, it is wrong to pay too much attention to 1 month changes in price indexes. But I will go out on a limb in saying that the inflation rate in the United States in the summer of 1985 will be lower than at any time for many years. In large part that is a consequence of a policy change which I date to the G-10 agreement when Secretary Regan was still in the Treasury in late January 1985, the first time expressing an almost open-ended willingness to intervene in the exchange markets for what I regard as at best, a temporary objective to defer the protectionist pressure until after the 1986 election, which is probably, I think, the most accurate statement of the objective of this policy.

Chairman NEAL. One question that has been nagging at me for some time, and again I am not picking on you, Mr. Fox, it is just that you happen to have made a couple statements that make me ask you these questions.

Representing the private sector, the business sector of the country, you recommend to us somehow manipulating the value of a commodity—money—when it would seem to me you would be very much opposed, or I would imagine you would be very much opposed if we were to set target values for the value of real estate, homes, or butter or anything else.

I just find that inconsistent with what I think is the idea of a market system.

Mr. FOX. Let me explain, Mr. Chairman, if I may.

The manufacturers have an interest that is not precisely the same as the financial sector of the market—the banks, et cetera. The manufacturers have an interest in manufacturing and in trade. The burden of failure of floating has been borne more in manufacturing, to some extent in agriculture, but more in manufacturing than in any other sector.

That burden is not transitory. Some of those closed plants will never be reestablished no matter what the exchange rate is.

Our interest is not theological. Our interest is in producing goods in the United States, selling the goods at home as well as exporting them at competitive prices.

If the present exchange rate system adds 35 to 40 percent to the price on our exports and gives a comparable degree of advantage, roughly, to the price of imports, American manufacturing cannot live with that.

Chairman NEAL. I understand, but——

Mr. FOX. Excuse me, it is just not a few sectors. That is from the greatest high tech company in the country, perhaps IMB, to the smallest company. It is not a theoretical exercise. If I were to prescribe, I would say we have a wonderful opportunity now. We have the opportunity to observe the G-5 process which has an element of currency intervention and an element of macro direction to it.

Let's use that experience and thoroughly understand it before we rush to the next change in the international monetary system.

In retrospect, it is obvious to me although I don't hear my colleagues saying it these days, the U.S. Government should have attempted to defend the March 1973 rates. That was the second dollar devaluation, close to 20 percent at that point. We should have broadened the Bretton Woods bands and tried to defend those rates.

Maybe they couldn't be defended at that time because of the oil price shocks and commodity price shocks, et cetera, but there is a valuable element of experience that was lost when we went to floating. We had relatively satisfactory experience of floating in the mid 1970's and then things got out of hand.

I am not saying categorically that there is no place for floating. Most of the former supporters of floating now refer to it as managed floating with derogatory implications regarding the management aspects, and recognizing that management came mostly from other countries.

Now, if we cannot have an international exchange rate system that provides a reasonably adequate—by that I mean purchasing power parity related exchange rate—then American manufacturing will have to look to some other means. Now I don't make extreme statements in this regard, but others say you have to manage the money in some way or you will have to manage the trade. I think that is overdrawn. But I think we have the opportunity now in observing the results of G-5. Congress is in a perfect position to evaluate the results, and you don't have to just listen to the Fed and the Treasury and manufacturers, you can listen to the farmers and you can listen to the IMF and you can listen to foreign observers.

The system has to work for us and it has to work for other countries.

It doesn't have to give an undue subsidy to our two most important manufacturing competitors, namely Japan and Germany.

You got to wring that out of the system.

A final word, the IMF really has a responsibility here but has said very little. In part perhaps out of deference to the United States, which until September 22 was thought not to be favorable to a change. But the Bretton Woods system had no adequate means of dealing with surplus countries. There was a surplus current account provision of the IMF in the old Bretton Woods system, and it didn't work. Japan and Germany continued on with accumulation of reserves.

The floating system had no means of dealing with persistent current account surplus countries, either. It is one of the items calling for attention. I am not saying we are going to learn everything from G-5, but we have to bear in mind in the last 30 years we have not had a monetary system that dealt adequately with countries whose policies built up persistent and large current account surpluses.

Chairman **Neal**. You are attributing the problem to the exchange rate system, or to the fiscal policy we have been following?

Mr. **Fox**. I am saying they are both related.

We had an international exchange rate system that magnified the deficiencies in fiscal policy. I put a lot of weight on the budget deficit and all the harm that it has done and it is going to take a long time to unwind that. So one of my main points is the President and the Congress ought to deal with the budget deficit problem as promptly as possible. I certainly don't hold the view that Congress cannot keep two complex issues in its mind at one time. I simply say we have to pay attention to the exchange rate.

There is no country in the world with the possible exception of Hong Kong that doesn't look at the exchange rate. Even Switzerland looks at the exchange rate. Switzerland always had a sense of what the exchange rate ought to be relative to their trade interests. I think the United States simply needs to address the exchange rate policy along with monetary and fiscal policy.

Chairman **Neal**. Mr. Grotberg.

Mr. **Grotberg**. Thank you, Mr. Chairman.

With regret I came late and I am leaving early, I will ask my one question.

But I personally cannot conceive of a unilateral approach to exchange rates. So right away I stop ringing the bell because it is offensive to me. It would be a myth to think that America could do anything unilaterally about international exchange rates. We can set up a monetary policy, but I don't think Congress should be involved at this level. Isn't the whole thing conceived improperly? Am I wrong?

Mr. **Bergsten**. I think you are part right but at least an important part of both bills as I read them is to reform the functioning of the monetary system in which all the major countries would together try to harmonize their policies.

Mr. **Grotberg**. My point exactly.

Mr. **Bergsten**. And then we get a more balanced framework. Within that framework the United States would have to do things in its own.

Mr. **Grotberg**. The Treasury would have been out there foundering if it had not been the pressure from this organization. That is the key role for us, gentlemen. But writing a long-range policy or getting involved in one certainly takes more than the United States or the U.S. Congress in a world of international markets.

Mr. **Bergsten**. There is one additional point to make. If you had witnesses from most of the other major countries in the world before you this morning and asked them why exchange rates have gotten so out of whack the last 4 or 5 years, one point high on their list of responses would be the lack of cooperation from the United States in working with them, going all the way back to 1981, the London economic summit, and so forth.

There were very, very strong concerns expressed already at that time by the other countries about the implications of the booming U.S. fiscal deficit, high real interest rates, complete rejection of intervention in the markets, and so forth.

They would say that the failure of the United States to cooperate with them was going to be a major problem. They turned out to be right.

To the extent that these bills would try to get the United States to join the world—which I think is, in essence, what they were trying to do—they would lengthen the short leg rather than the reverse. In that sense, it is not so unilateral as you were suggesting.

Mr. **Grotberg**. World money markets, we have become isolationists. But it can't happen any more. If we act internationally on every other front and become isolationist on the monetary front, I perceive it as foolhardy.

I don't know the answer. I appreciate the drill we are all going through, Mr. Chairman, and the distinguished Congressman from Levinville. I have captured parts of this testimony, and I thank you very much.

Chairman **Neal**. Mr. Levin.

Mr. **Levin**. Thank you.

I think the last 20 or 25 minutes have been especially thought-provoking—the comments of all of you, your formulation of questions, and the Bergsten response.

Let me just say, as I throw out the last question I have, I would ask the two of you to formulate in a minute or so the difference between the two of you, what underlies that difference.

I think there is something besides—there is some larger perspective that brings you to a difference on this point. Tell me what it is. Tell us what it is.

Mr. **Niskanen**. Let me suggest—and Fred surely should respond—I think Fred isn't as concerned about inflation as I am. That is one difference. He is willing to risk a higher level of inflation for another goal, which is a lower nominal dollar, not necessarily a lower real dollar. He is willing to risk the higher level of inflation. That is one difference.

The second is that I think that he believes that people in the Treasury and the Fed, are more clever than I think they are. Fred used to work at Treasury, and I worked in the CEA watching both Treasury and the Fed.

He thinks they are more clever than I believe they are in recognizing when there are speculative bubbles and when the exchange market is divorced from fundamental conditions.

Anybody who can do that ought to have made a zillion dollars. And Fred has done all right, but he hasn't made a zillion dollars.

The track record of Government officials intervening in exchange markets is rather bleak. In other words, they have not bet right on exchange rates, with all the information available to them and their staff. They have not been particularly successful in intervening, even where there may be particular episodes, and maybe this last 6 months or so has been one of those episodes, in which it looks as if they have bet right.

Mr. **Levin**. You would have opposed this action if you had been——

Mr. **Niskanen**. Pardon?

Mr. **Levin**. You would have opposed this recent intervention, would you?

Mr. **Niskanen**. The G-5 agreements?

Mr. **Levin**. Yes.

Mr. **Niskanen**. Let me tell you what is happening on the G-5 agreements. It is basically a dollar-yen play. The Germans have managed to stay aside from this process.

Mr. **Levin**. In a word, if you had been—the President had looked at you and said the time has come for a yes or no on intervention, you would have said no?

Mr. **Niskanen**. I would have said no. I think that one of the two or three major accomplishments of the President in economic matters is that the inflation rate, came down by two-thirds or more since 1980.

I think that the intervention policy that has been building since the G-10 agreement of last January is very likely to reverse one of his major accomplishments, possibly by the end of his term, and that done in the name of bringing the nominal exchange rate down.

Now, in the short run, if your action is a surprise, you can reduce the real exchange rate, because inflation has not yet caught up. But in the long run, you can't affect real exchange rates by monetary policy. You can only affect it by other kinds of policies. So it looks to me—and I am really quite critical on this regard of the administration's behavior—it looks as if they are buying time to relieve themselves from protectionist pressure for a period of time until maybe after the 1986 election.

But the only way that that can be ratified over a period of time is by addressing the real conditions, and the exchange market policies by themselves do not do that.

Mr. **Lundine**. Would the gentleman yield?

Mr. **Levin**. I see that you have to go, so let me yield to you.

Mr. **Lundine**. I am not going to ask to ask an additional question.

Chairman **Neal**. Please, ask all you want.

Mr. **Lundine**. Could I ask one additional question in writing that would become a part of the record?

Chairman **Neal**. Please. And I would hope the witnesses would respond.

Mr. **Niskanen**. Yes.

Chairman **Neal**. Fred.

Mr. **Bergsten**. Bill's first comment is not correct. I am not soft on inflation. I think, however, that the United States exported a great deal of inflationary pressure through the strong dollar over the last 4 to 5 years. I think correction of that dollar overvaluation is inevitable as well as desirable. We ill, therefore, reimport some of the inflationary pressure exported in the past, and over the long haul it will net out.

We now know the secret of supply side economics. Foreigners supply most of the goods and all of the money. As long as that continues to happen, we export some inflation. But when it reverses, it nets out. So, over time, it will net out. That is a prediction maybe slightly different than Bill's, but I am no softer on inflation than he is.

Second, and this is one of our two big differences, I think, Bill really believes in the efficiency, almost the perfection of private markets. I am very skeptical. As I look at commodity markets, money markets—not just the exchange market—I see long periods where subsequent events showed that they have not been reflecting the underlying economics, and so governments may not be so smart but they can at times correct fantasies that exist in the private markets.

When I was in the Treasury, the dollar became too weak. We did not like the inflationary consequences. Hence, we had the Fed raise the discount rate sharply, put together a $30 billion package to defend the dollar in 1978, as the chairman well knows, and it worked. It took a while, but it worked, and it reversed the situation and began to work down U.S. inflation.

Mr. LEVIN. You say governments can correct the fantasies in the private market. Can't government also correct the policies of other governments?

Mr. BERGSTEN. In addition——

Mr. LEVIN. Which seems to me your formulation leaves no room for, Mr. Niskanen. If other governments are following policies that are harmful to us, essentially you seem to be saying that is the operation of international markets.

Mr. NISKANEN. No, no.

Mr. BERGSTEN. I would have thought both of us would have said that there must be changes in policy. And Bill, I think, said clearly in his original statement the budget deficit should be reduced.

Mr. LEVIN. I am talking about other countries' policies.

Mr. BERGSTEN. Well, other countries, too, I think Bill would say.

Mr. NISKANEN. Yes.

Mr. BERGSTEN. There is another difference you should realize, and it is that we use different models. I think now M1 is largely irrelevant. Bill says it has been rising more than 10 percent for 3 years, and therefore we will have inflation.

The monetarists were telling us that in 1982 and in 1983. They were telling us that again over a year ago.

Inflation has continued to decline. It is at the lowest level in over 20 years. The monetarists so far have been proven wrong.

Now, Bill says he is willing to bet that we have had the trough. I don't think so. I think October was a 1-month blip. The last 3 months are still zero on—wholesale price index—less than 2 percent over a year ago. I am willing to bet him a steak dinner. I think inflation will stay low.

Mr. LEVIN. We are witnesses to that.

Mr. BERGSTEN. But the point is, he is operating off a model that looks at certain variables. The importance of the money supply defined by M1—which, because of structural changes in the economy and the way the financial system works, has become largely irrelevant as a guide to anything—a big difference between us.

Mr. **Levin**. Thank you.

Chairman **Neal**. Mr. Niskanen, I must ask this question. You just made the comment that the accomplishment—I think you said the only accomplishment of the administration——

Mr. **Niskanen**. One of several.

Chairman **Neal**. One of several.

The major accomplishment of the administration was bringing down the rate of inflation.

I need to know what policies of theirs have accomplished this wonder. We double the national debt. We have taken the interest payment from $60 billion to $140 billion a year, pumped up the money supply in recent years.

Leaving the money supply out of it, as I look at their policy—say, I am trying to formulate—we are in another inflationary period 20, 30, 40, 50 years from now, and I am looking for policies that will bring down the rate of inflation.

So I go back to the wonderful, successful policies of this administration and I say, oh, I found it. We will double the national debt over 4 years. You can go through the major things—increase the level of Federal spending enormously, any way you look at it.

Is that really what brings down the rate of inflation?

Mr. **Niskanen**. No, no. I think the deficit is basically irrelevant to inflation, at least in the short run.

Chairman **Neal**. What policy of the administration has brought it down, then?

Mr. **Niskanen**. I think it was first a result of the sharp reduction of money growth until mid-1982.

Chairman **Neal**. What did the administration have to do with that?

Mr. **Niskanen**. The Reagan administration was the first administration to highlight monetary policy as being the key determinant of inflation.

Chairman **Neal**. Excuse me.

Mr. **Niskanen**. In February——

Chairman **Neal**. Mr. Carter hired Mr. Volcker for the precise purpose of reducing the rate of growth in the money supply.

Mr. **Niskanen**. In February 1981, the administration asked the Fed to reduce the rate of money growth on a slow, steady basis—this is almost an exact quote—to a level that is half the 1980 level, by 1986. That was the explicit preferred target path of the money supply announced in the economic recovery program on February 18, 1981.

The Fed reduced the money growth much faster than that projected path for about 18 months until mid-1982. That, I think, had a very desirable effect on inflation through 1984 and 1985. It also led to an unusually long recession in late 1981 and through 1982.

The second, and unappreciated, effect is that a large part of the reduction of inflation, particularly the fact that it has been sustained through 1984 and 1985, is the consequence of the strengthened dollar. I attribute the strong dollar almost entirely to the fiscal policies of the administration.

I think the primary effect, although not the sole effect—as my former colleague, Bill Poole, articulated here last week—was the 1981 business tax provisions in ERTA, which significantly increased the posttax return on business investment in the United States, increased total demand for investment in the United States. The administration's policy proved to be incoherent in the sense that it not only increased the demand for investment, but because the deficits ballooned, it reduced the net supply of savings.

So, you have both the demand increase and supply reduction. But the evidence is that the demand increase was much stronger because, in fact, we had a big investment boom until the last quarter or so, an investment boom of almost unprecedented magnitude.

So I think that a large part of the reduction in inflation has been a consequence of the strong dollar.

Now, the administration, for reasons that I do not understand, appears to have reversed both its tax policy and its monetary policy. The Treasury I tax proposal would have reduced the posttax return on investment by about 10 percent. The President's tax proposal would reduce it by about 4 percent. But Ways and Means seems to be up to a much larger reduction in the return on investment than what the President proposed.

In addition, starting last winter, or the administration seems to have reversed its position on whether domestic monetary policy should be subordinated to exchange rate conditions. They had a clear policy, as I think Fred has recognized, that we ought to be running domestic monetary policy in terms of our domestic concerns and not be driven by what happens to the exchange rate. I think that that was a correct policy at the time, and I regret that they have departed from that policy.

I think it is also important to recognize—it is important for the business community to recognize that, they can't have it both ways. They can't maintain the kind of business investment incentives that are in the 1981 bill, even as modified in 1982 and 1984, and expect the dollar to drop very much, because I think the primary reason the dollar is as strong as it is is the consequence of those investment incentives rather than the deficit.

I don't want to dismiss the consequences of the deficit. I think that they are important. They have just been overwhelmed by these other phenomena.

The most important measure that would lead to a soft landing for the dollar would be to increase the net supply of saving in the country. And the most important way to do that is to reduce Government borrowing. And, in addition, it may very well be important to address the structure of our Tax Code to reduce the bias of our tax system against private saving. That would lead to a soft landing for the dollar that is consistent with maintaining a favorable investment climate and without the monetary actions that would reduce the nominal value of the dollar.

I think it is also important, however, for the general community to recognize what, in fact, has happened in the total goods sector and the manufacturing sector. The last time I looked, the manufacturing share of output in this country has been roughly constant for 30 years, including in the last several years. The goods share of output in the United States, which is mining, agriculture and manufacturing, et cetera, last year was higher than in any year since 1957. So, there has not been a progressive deterioration of the manufacturing sector and of the goods sector in terms of the outputs of that sector.

What has happened is that the manufacturing share of employment has dropped, and that has been going on for 30 years. The manufacturing share of employment has been dropping for a large period of time, and the absolute level of manufacturing employment has dropped about 1.6 million since 1979.

But that is, in part, a consequence of what has been a continued unusual growth of productivity in the manufacturing sector. There are selected manufacturing sectors that have had severe losses, those that are most trade dependent. In a number of those cases, they have been substantially of their own making.

I left Ford Motor Co. in the summer of 1980 when Ford filed a 201 petition against Japanese imports at a time when the yen was at 180 to the dollar. The exchange rate, a very weak dollar in terms of the yen, was not sufficient to protect the auto industry against consequences of their own making at that time.

Now, Fred, for some reason, thinks that that ought to be the right level of the dollar. If you ask the businessman what the right level of the dollar is, he generally will do his own calculations and say it is the price at which he can make money competing against the Japanese. But that number is going to be very different for different businessmen. It is not a right level of the dollar in terms of any sense of our general interest.

Chairman **NEAL**. Let me, if I may—and I don't want to pursue this too long—but I do want to say this: I believe your answer to my question was that the administration's role in bringing down the rate of inflation was to not fire Paul Volcker, but to allow him to restrain growth in the money supply without too much public criticism.

And I also hear you saying——

Mr. **NISKANEN**. The administration, for the most part, has reinforced Volcker's relative tightness in money growth through 1982 or so. I think that that was an important thing to do.

I think, also—and what is not as widely recognized—is that the administration's tax bill of 1981 has had a very substantial effect on the dollar and, in turn, on the inflation rate.

Now, both of those policies seem to be coming unstuck. The administration seems to be willing to accept a continued or even higher growth of the money supply, and it seems to have reversed its position on the value of those business tax incentives.

Chairman **NEAL**. I hear you.

You said, if I heard you correctly, that in one context you felt it very important to bring down the budget deficit, I think in the context of reducing the amount of payment of interest, although I am not sure of that.

Mr. **NISKANEN**. Increasing net savings in the economy.

Chairman **NEAL**. Exactly.

I know that your preference would be for spending cuts.

Mr. **NISKANEN**. Yes.

Chairman **NEAL**. If we are not able to get the spending cuts adequate to do that in a significant way, what is your recommendation?

Mr. **Niskanen**. Well, Mr. Chairman, if it is appropriate for the Federal Government to spend 24 percent of GNP, then we will have to sooner or later, tax ourselves to that level.

Chairman **Neal**. Three-and-a-half percent of that——

Mr. **Niskanen**. I am not prepared to accept the conclusion that we should spend 24 percent of our GNP through the Federal budget. But if our political system, for whatever reason, chooses to spend that much through the Federal budget, then it is just an arithmetic conclusion that sooner or later we will have to tax ourselves to roughly that level.

That is an arithmetic conclusion, however, and not a policy recommendation.

Chairman **Neal**. I agree with both of your points. We shouldn't be spending that much of our GNP at the Federal level, and if we are going to, we ought to tax for it.

I would just have to point out that 3 or 3½ percent of that 24 percent is interest payment on the national debt, half of which has been accumulated in the last few years. You know, the spending on other than interest on the national debt is very close to what I, myself—whether anyone else agrees or not—would think would be an appropriate level, which is about 20 percent of GNP.

We are now spending 21 percent of GNP, which is really not too far from what I would consider to be an important long-term goal on real spending other than interest on the national debt, which is 3 or 3½ percent.

Mr. **Bergsten**. On your puzzlement, Mr. Chairman, about what the administration did to bring down inflation, in a strange way those budget deficits helped bring down inflation.

Chairman **Neal**. That is what Mr. Niskanen is saying in a way, because it strengthened the dollar.

Mr. **Bergsten**. I agree with him that the administration's fiscal policy was the major cause of the strong dollar. I see a different chain of causalty. I think it was the pressure which the deficits put on the money markets, putting up higher interest ways and sucking in capital from around the world to make the dollar so strong.

But in a peculiar sense, that was a major cause of the reduction in inflation, because I agree with him that the rise of the dollar had an effect probably reducing our consumer price index by 2 percentage points a year.

But when that effect is reversed, as it must be, then we will reimport that inflationary pressure.

I don't want people to panic when they see inflation rise temporarily as the dollar weakens. When the dollar levels off, albeit at a lower plane, the inflation rate will drop back to the underlying core level.

But there will be a temporary period when some increase in the recorded numbers shows up as the dollar declines.

So there could be some temporary effect of that type.

But it is very important that that not then be ratified in wage settlements, monetary policy and the like, recognizing that it is just a temporary reversal of the good news we got in the past.

Chairman **Neal**. But when you say, let me ask you, "To its core level", I understand from your exchange with Mr. Niskanen a few minutes ago that you expect that core level to remain for some long period of time at whatever, 3 or 3.5 percent. Why? If there is any relationship that has been a good predictor of economic activity over the centuries I guess, it has been money growth. I am not a strict monetarist. But if you just look at that relationship, and I don't feel I can begin to understand that whole—I think it has something to do with the fact we are running these enormous trade and budget deficits but I have great difficulty understanding why that relationship appears to have broken down.

It does not seem a very good bet to bet, based on historical experience, to bet against a resurgence of inflation.

Mr. BERGSTEN. Well, if the Congress and the administration don't get together and at some point bring the budget deficits down, then I agree, there is a risk that ultimately some successor to Paul Volcker, due to pressure from some, may start monetizing the debt.

Chairman NEAL. You don't think they are doing it already?

Mr. BERGSTEN. No; I don't. I make a distinction between the point you just raised about using money growth as an indicator and using any particular proxy for money growth, such as M1. My comment before was not at all to negate the notion that money growth as important. It was simply to negate the mechanistic view that some certain growth in M1 as an indicator of money growth will inherently produce inflation down the road.

I think M1 has been changed all out of proportion. It has really lost most its meaning because of deregulation and the reduction in inflation and interest rates themselves.

Chairman NEAL. If you look at every measure of money growth, hasn't it been up?

Mr. BERGSTEN. No.

Chairman NEAL. If you look at the monetary base, M1, M2, M3?

Mr. BERGSTEN. It depends on the Fed targets. Only M1 is above the Fed's own targets. M2 and M3 are within the targets. You may say the target ranges are too high, but I haven't heard much of that. The other M's are within the targets. There is no specific target for the money base. I don't know whether most economists feel it is too strong or not. I don't think so. I think it is only M1 that is peculiarly up there, and Bill cited the numbers correctly but that is the aberration.

I really see it as an aberration. I think, just to tie it back to what we are talking about on the exchange rate, if you think that a dollar correction is inevitable and desirable, then the only issue is when to take it. I happen to think now is about the least bad time to take it because the inflation rate is way down so you could accept this temporary buildup with a little more equanimity. Demand in the economy, in my view, is very soft now.

I think we have a very soft economy now and out through 1986. So you don't have much demand pressure. So even though a declining dollar will generate inflationary tendencies and maybe even a tendency for interest rates to rise, I don't think they are actually going to go up very much in absolute terms because the economy is so soft. Credit demand is soft. Commodity prices have continued to sink, despite the OECD recovery, despite the low dollar, despite low interest rates.

It is hard to see inflation pressure anywhere in the world economy today unless you are a believer in M1. There are almost no other signs. Wage increases are running 3 percent or less. When you ask about a core rate, many economists would say since wages make up something like two-thirds of national income, the best indicator of the core rate of inflation is what will happen to wages. They have been continuing to decline, they are running on an average 3 percent or less in the latest settlements.

That makes me very encouraged, not only about inflation now but the outlook for the future. I would ask Bill and others, what signs other than M1 are there that inflation is going to pop up? There will be the temporary risk when the dollar comes down. Even then the absolute amount is likely to be very small. I don't see any underlying economic forces giving us any suggestion at all that inflation is going to come back.

Chairman **Neal**. Mr. Niskanen, would you care to comment?

Mr. **Niskanen**. Well, there has characteristically been a roughly 2-year lag between M1 growth and inflation. So one cannot look at current signs of inflation to indicate whether we are likely to face future inflation. We have to look at the processes that have generated that.

Mr. **Bergsten**. You noted M1 has been shooting up for 3 years.

Mr. **Niskanen**. I realize that, M1 has been going up for several years. I regard myself as a low church monetarist in the sense that money is very important, but that we should not assume that the relationship between any particular monetary aggregate and the higher economic aggregates are likely to be stable.

There has been a significant reduction in the growth of the money velocity. M1 velocity growth looks like it is much more consistent with M2 velocity growth in the past. Current M1 looks like it is behaving more like M2 did in the past, which had no net velocity trend over a period of time.

I don't pretend to understand all of what is going on in the market. I am perplexed, for example, by the combination of high money growth and a booming stockmarket and still fairly sluggish short-term demand. It is a phenomena that I don't pretend to understand, but often resolving such puzzles leads to new understanding.

I am working on it.

My own expectation is that we will have a quite robust economy next year but I have been expecting that for some months, too, I must acknowledge.

Chairman **Neal**. Well, I——

Mr. **Niskanen**. We have had for some years now a deviation in what had previously been a normal relationship between the monetary aggregates and nominal GNP, but it is extremely dangerous to say that money doesn't matter any more or particularly that M1 doesn't matter. For the most part, M1 has been more closely related to subsequent changes in nominal GNP growth than the other aggregates.

To say at any given time that one should pay no attention to it, I think is really quite dangerous.

Chairman **Neal**. Mr. Fox.

Mr. **Fox**. Since you have given me the last word, I cannot refuse that. I really want to stay out of the argument that you and Mr. Levin have put Fred and Bill up to. I do want to say we have got to be able to look in this country at several variables at once. We cannot take the exchange rate one and say that is the only one, or monetary indicators are the only one, or inflation is the only one, interest rates, growth rates, we just cannot do that any more.

It is a more complex world and we are going to have to constantly adjust and think of one tradeoff against another.

Probably in terms of the fundamentals, savings investment is the most important set of relationships we have to keep our eye on. That relates to, in great part, to tax rates but it also relates to other matters.

I have the feeling that we have lived through a decade now where one aspect of the system has served us rather poorly, and that is the exchange rate portion of the picture.

My purpose today was limited to that and it really is to try to help figure out a better way to do it.

I think excessive certitude about what did or did not cause what took place in the last 12-year period will not serve us very well. We have the opportunity to observe a new approach to the policy and to participate in it. Congress has an opportunity to participate in it. I hope that this G-5 experience will be a useful one and not an opportunity lost.

I must comment on Mr. Niskanen's comment on industry. Industry has not done well in this period. Profits are very, very low for the type of business cycle expansion that we have had. If this is the best set of policies that manufacturing can expect, then our problems are even more broad than one would have thought.

In NAM the two priorities that most characterize our policies relate to reduction of the budget deficit and reduction of the trade deficit. We are willing to try a few things that maybe we wouldn't have tried a few years ago to see if we cannot accomplish both.

Chairman NEAL. Thank you.

I would like to thank all of you for being so patient, especially with me. I think we are back to the situation of the one-armed economist. We certainly don't seem to be getting the definitive answers.

When you figure out why this relationship broke down, would you please share it with me, Mr. Niskanen? I would very much like to know.

Mr. NISKANEN. Yes, sir.

Chairman NEAL. Do you have another 2 minutes?

There is something Fred said I would like to ask you to expand on if I could.

Fred, you said something about regularly seeing wild misrepresentations of true value in the marketplace or something like that. I really don't think I understood what you were getting at.

Mr. BERGSTEN. Well, let me give you an example.

I have asked economists around the world over the last few weeks to tell me why the yen-dollar rate more accurately represented the fundamentals at 240 to 1 two months ago than at 220 to 1 one month ago than at 202 today, or maybe 182 a month hence. No one could answer that question.

The state of the art is not such that anybody can define within that fairly wide range which now we are talking about, 25 percent——

Chairman **Neal**. Isn't that why we rely on the market?

Mr. **Bergsten**. No.

Chairman **Neal**. You can say the same about an individual stock on the stock market maybe that doubled in value in a month.

Mr. **Bergsten**. No, but my point was going to be that the officials may have been right in their statement on September 22 that the markets had not taken into account some changes that were going on in fundamentals.

Secretary Mulford mentioned some, Bill from a different standpoint mentioned some on this panel, that really changed the underlying relationships between countries.

Nevertheless, the dollar, while it had begun to come down some from its peak of last February, had not really come down all that far. So the governments gave it a shove, leaning with the wind and I would submit that that will be successful. I don't think those rates are going to bounce back up.

My point is that the markets do tend to have a self-propelling inertial effect. In the exchange markets you will frequently get the view from participants that almost the whole current generation of market traders, who are young guys usually between 18 and 25 years old, have throughout their career known that you made money by buying dollars. They have not known why. They don't even know the economics of it. That is irrelevant. Their time span runs from 30 seconds to 30 minutes. But they know you make money by buying dollars.

They kept buying dollars and kept buying dollars, and the dollar went to 3½ marks from 1.6 marks in 1978. Now it is back to 2.6 marks and it is maybe headed to 2.2 or 2.3 marks.

When I say markets are irrational in that sense, Mr. Chairman, what I mean is they are not fulfilling what I think—and it is a normative judgment—their function, which is to align more or less the underlying competitive positions of national economies. I am very open to say that that is a normative judgment. That is what I think the exchange rate should do.

If it doesn't do that, you get enormous distortions in national economies of the type Larry Fox has reported from the business community, of the type we see in the trade deficit, in the fact we see the United States becoming a debtor country and protectionist pressures you see here. It just won't wash either with our internal economic and political system nor with international compatability with other countries and the world system. It just won't be sustained.

If it won't, then I think the exchange rate is not doing its job. That is why I say the exchange rate, like other market prices, frequently takes on a life of its own which doesn't reflect any underlying economic rationality.

You are right. One can sit back and say, but no individual or government is smart enough to do that very precisely either, so just let the market run. Then you come to a judgment of costs and benefits.

I think within fairly wide ranges, which is why I advocate target zones, you can and should allow market forces to affect the exchange rates. The problem is when they get so far out of line, 20, 30, 40 percent compared with the underlying trade competitiveness, that then I think you create these enormous problems for real economies and the situation is not going to be sustained anyway.

So what you have in essence done is watched a particular price shoot up in one direction, know it is going to have to come down at least most, if not all, of that way in the future, with a lot of pain in between for essentially no net change. So why do it?

When you asked the question about, don't we believe in market economies around here, I remember a story that one of my wonderful graduate school professors in economics, Charlie Kindelberger, told. He said, "We all believe in market economics, so when we queue up to get on a bus, the price should be auctioned and we should bid for the seat. Whatever you are willing to pay, you get the seat; if more people are there, you bid up the price of the seat and sell it."

The point is that some prices are too important to be left uncertain and therefore totally to the vagaries of the market. We don't want to change the price of a bus seat every time we get on the bus.

A trader doesn't want to have to guess whether the tractor he sells will fetch him 150 yen this week or 300 yen next week or vice versa, and I think it is that predictability for the business and economic environment combined with the relevance of the relationship among underlying economies that suggest that this price should not be allowed the luxury of total market determination.

Chairman NEAL. Yes.

Mr. NISKANEN. Markets are not perfect. Fred's particular anecdote, however, is irrelevant. There is no queuing in auction markets. There is no queuing like there is in the bus terminal.

Mr. BERGSTEN. Some people wouldn't get a seat.

Mr. NISKANEN. I know, but that is not an imperfection of an auction market like the exchange markets.

Now, the other major thing to recognize is that changes in the exchange rates reflect not only demand in and supply of traded goods, but reflect changes in the demand and supply of capital. The latter effect is the primary reason why exchange rates can differ from a purchasing power parity relationship by substantial amounts for substantial periods of time.

You may not like that, in the sense that if you are in the traded goods sector, that could lead to a boom-or-bust cycle in the traded goods sector, but the alternative to that is to have a system that, in effect, does not allow exchange rates to reflect changes in the demand and supply of capital.

A fixed exchange regime has the same problems when there are shifts in the demand and supply of capital. It is difficult to maintain fixed exchange rates under those circumstances without really massive twists in internal policy.

The market is reflecting economic fundamentals when it is changing to reflect changes in the demand and supply of capital as well as changes in demand and supply of traded goods. I think it is unrealistic to judge the market on the basis of how well it performs relative to purchasing power parity. That is not the only guide for how that market ought to respond.

Now, I invite anybody who thinks that they can beat the market over a period of time with access to all the information available to

Government, except changes in policy, to see whether they can beat the market in determining whether the market is reflecting fundamental economic realities. I am confident, that with all the resources available to the Government, they could not beat the market unless they in fact are changing policies over time. They may on occasion. They may have in fact the last 6 months. But I think that the possibility of them doing that over a period of time is not important.

Now, as I said earlier, I think the major reason why the dollar has departed so much from a purchasing power parity relationship in the last 4 years is that the demand for capital in the United States has increased very rapidly relative to that of other countries.

The alternative if we had closed off our capital markets from international discipline or international flows, is that the increase in the demand for capital associated with the big budget deficit would have led to phenomenal interest rates in the United States.

You just can't have it both ways. You can't have that exchange rate stability, Larry, that you want or at a lower level, and provide an opportunity for the United States to invest a good bit more than it has been saving. That is what the exchange rate has permitted us to do.

Mr. Fox. Maybe I could say if it had not been so easy to let the budget deficit get out of control because the system provided for massive capital inflows, we would not have let the budget deficit get out of control and wouldn't have gone to 15- or 20-percent interest rates.

My point is you have to watch a number of variables at one time. Your formulation basically concludes that the tradable goods sectors of the U.S. economy can stand abuse for an indefinite period of time.

I am saying that simply is not the case, and I am not prescribing that we forget about inflation. Just the opposite.

But we have to learn to live in an integrated world, and in an integrated world, the United States interfaces with other countries primarily through the exchange rate.

If we have an exchange rate that is 30- or 40-percent out of whack for a persistent period of time, there are real costs associated with that and we have borne those real costs in manufacturing, farming, and to some extent in mining. And my intuitive view, my experience and my knowledge and my intellect tell me there must be a better way to do it than the old version of floating.

I urge that we try some new experience in which the market plays a very important role, and none of us can erase the role of the market, and see what we can do in this current situation.

Mr. NISKANEN. I am prepared to acknowledge that surely we can do something better than we have done in the last 4 or 5 years.

There are some obvious things we ought to be doing, like getting our budget deficit down.

But, I don't want us just to be playing with monetary policy or playing with exchange rate policy in the hope we can learn something in the meantime. These are dangerous weapons to use, and I think that we ought to have a lot more clear thinking about what a realistic alternative is before we move very far down that road.

It may be that at some stage we ought to have a serious international monetary conference, but we are a long way from the conditions in which that conference is likely to be successful. The most important thing that has to be thought through in the first place is what change in rules is likely to be recognized by all of the signatory parties to be a superior set of rules to the ones we have agreed to now, not what set of rules might be temporarily favorable to the United States.

That is not a basis for an international agreement. If our manufacturing sector is hurting, that is not a sufficient basis to go to the Europeans and Japanese to say that, hey, we want to change the rules because we are hurting.

We have to think through a change of rules in which we can make a case to them as well as convince ourselves that that change of rules is superior to the rules under which we have been operating.

I have yet to hear of a proposal that offers that promise. What we have right now is a general expression of concern about living with uncertainty, people don't like uncertainty. They would like some dimensions of uncertainty resolved without recognizing that there may be some very important tradeoffs that have the effect of increasing the uncertainty on more important issues.

Until we have thought much more clearly than I have seen to date, whether it is in the congressional summit last week or in other forums, about a realistic alternative and evaluated whether that is likely over a period of time to generate benefits to all the signatory parties that are superior to that of the present system, I suggest we are not ready.

Mr. **Bergsten**. Mr. Chairman, just two quick points in response to Bill. I think it is not quite right to say that anybody would be thinking of going to the Europeans and asking them to change things because we are hurting.

We have tried through our work to suggest that it is not in the interest of Europe either to have exchange rates so far out of line. When their rates are very undervalued as they have been, that adds inflationary pressures to their economy, forces them to push interest rates to levels higher than called for by their underlying economics.

They also feel that the risk of a protectionist outbreak here would be adverse to their trade. They even got wrong price signals when the mark and yen were undervalued through the whole of the 1960's. For example, they built up a lot of industries on the basis of exchange rates that were too weak, then when things got back to balance as inevitably they do, those industries came in for subsidies and protection and so on and saddled their economics with some white elephants, so it is not necessarily in your interest to be either over or undervalued.

I don't think it is just a U.S. problem or U.S. corporate problem to say the monetary system is out of whack. Moreover, if you think it is only overvalution as a problem, then the Europeans and Japanese faced that in the late seventies when the dollar was too weak. So they have seen the other side, too.

So I think, Bill in his statement laid out three correct criteria for whether you need monetary reform. The first one concerning unhappiness with the current system, I think there is widespread and growing concern about the current system and on that criterion, I think, not only the United States is exhibiting difficulty.

Bill's second criterion, one he just came back to, is whether there is a regime that gives some promise of doing better. We can debate that. I think the target zone system may, in fact, help do that. Certainly, we should be moving in that direction.

Finally, I just want to record that I agree with Bill's analytical point a moment ago that the exchange rate now is reflecting capital flows as well as trade flows, obviously, because it is the capital flows that have swamped the trade payments and has driven exchange rates out of line, distorting trade relationships.

It may be we cannot simultaneously have free trade flows, free capital flows, and stable exchange rates. We may have to make some policy choices among those, and when you do that you then come to some normative judgments. I tried to be clear before. I was making a normative judgment of what the exchange rate should do. I think the price is too high when the rate does not more or less roughly equilibrate the trade competitiveness of major countries, and I pointed to the evidence of the last few years.

But that is a normative judgment. It is saying if it comes to a crunch I would rather manipulate the capital flows in order to preserve the freedom of the trade flows than the other way around. I am afraid that with the pressures we have to restrict trade in this country, in large part because of the strong dollar, that may be a choice.

Therefore, when the Treasury and Fed engage with the other major countries to manipulate capital flows through intervention, which is what they are doing, I think that is the right way to go, but it is a normative judgment, one has to be clear about.

I think analytically we would, at least on this one, take a similar view.

Chairman NEAL. I thought several times in the course of this conversation that what we were in a way talking about here is a priority.

Mr. BERGSTEN. And distributional effects. As Larry said a moment ago, a lot of manufacturing, much of agriculture, much of mining have really been hit by this, but interest sensitive industries are benefited. Housing has benefited.

Chairman NEAL. Sure, absolutely. It has been a trade off. If the situation becomes reversed, the impacts are going to be reversed, right?

Mr. BERGSTEN. That is right. So there are big distributional effects, therefore, political effects, and one makes a judgment. But part of my judgment has to do with long run sustainability. If you think the whole thing has to reverse, why go through the pain in the meanwhile?

Chairman NEAL. Two other points I have to put in here: I guess I would ask this question: If we are riding with the wave or with the wind or whatever the analogy is here, why bother? It is going to happen anyway.

Second, just to get to it before I forget it, I am torn on this question of whether or not we are dealing with the fundamental or symptom. I think my judgment has been that what we are really talking about here is a set of underlying economic factors in the exchange rates, not the cause of the problem.

Mr. BERGSTEN. On the first point, Mr. Chairman, there is a very strong reason to lean with the wind and that is to make sure it goes far enough to get you back to my normative area of underlying current account equilibrium. During the period of the dollar's enormous rise from mid 1980 to early 1985, there were at least three periods where there was a quite substantial midterm correction where the dollar did come back off quite substantially.

It wasn't just a straight line dollar rise. It would go up and down a bit, go up and come down. There were several periods in which it began to correct, but every time it not only petered out in that correction, but it went up further than before. I am not so sure what would have resulted if there had been serious cooperative intervention on one of those occasions when the dollar started to come down. It would have demonstrated the officials wanted it to correct and were willing to put their money where their mouth is, and push it as they are now. Maybe we would not have had that last big increase in the dollar of late 1984 and early 1985.

The reason to lean with the wind is to be sure the wind keeps blowing in that direction until underlying equilibrium is achieved. Now that leads to your second question: Is it a symptom or is it the fundamentals? I think the honest answer is that no economist or market participant can tell you how much of the existing exchange rate level is fundamentals and how much is what I keep calling speculative bubble.

I think there is a fairly wide consensus there is some of both. Some people might say it is half and half. Some might say it is 90 percent fundamental, 10 percent bubble. But, I think there is a fairly widespread feeling, and I think Bill was agreeing with this earlier, too, that there was some degree of market inertia feeding on itself in that last rise of the dollar 1 year ago.

That could be corrected by intervention and announcement effects and the like, which in a sense was only dealing with symptoms, but could be effective because the runup itself was not based on fundamentals. The distinction I make is that part of the problem certainly relates to fundamentals: the Japanese savings excess, interest rate differentials, budget deficits, whatever. Those are fundamentals.

I would certainly agree we are not going to get back to anything like a sustainable pattern of currency relationships for the longer haul unless those fundamentals are changed, starting with the budget deficit here, but also getting to more expansionary efforts in Japan and Germany, and a few other countries.

I fully agree on that. Where I would differ from some, I guess, is in thinking that at least the amount of correction that has occurred so far in the G-5 effort and maybe some more can be achieved without doing those other things.

Now, I would say that is decidedly inferior. We should be doing it along with the fiscal policy changes and the other fundamentals. But you can still get a fairly sizable amount of currency correction, and I would give independent importance to that because of the effect on U.S. manufacturing, agriculture, protectionist pressures, and debtor position and all that.

Chairman **Neal**. Well, thank you all again. We would please have you stay in touch with us if you have other ideas on this. We would welcome any of your comments.

[Whereupon, at 1:15 p.m., the subcommittee was adjourned subject to the call of the Chair.]

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